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New Developments in Tax Accounting

By Henry B. Jordan

Introduction

The year 1961 was not a routine year of tax accounting developments. The tax message of the new Administration contained some novel tax accounting proposals, while the much-heralded Treasury depreciation survey initiated in July 1960, and on which some legislative action was hoped for in 1961, was generally ignored. Like the French at Verdun (They shall not pass!), the Treasury adamantly continued its protection of the revenue, by attacking and otherwise discouraging tax savings through the use of tax accounting changes. There was one instance, however, in which the Treasury provided rules which, in the light of earlier standards, must be considered liberal. This was the issuance of dollar value LIFO inventory regulations, which with other principal developments are discussed later in this article.

Congressional Activity

In Public Law 87–109, signed by the President on July 26, Congress authorized certain "membership organizations" organized without capital stock, no part of the earnings of which is distributable to any member, to elect to include prepaid dues income in gross income for the taxable years during which the organization has a liability to render services or make available membership privileges. This new law is patterned after section 455, which grants a similar privilege to taxpayers with prepaid subscription income, and it contains many of the same limitations and restrictions.

Section 456 effectively overcomes, for taxable years beginning after 1960, the June 19 Supreme Court decision in *American Automobile Association* so far as it affects membership corporations similar to that taxpayer. In that case the Court decided that the

prepaid dues income of the accrual method taxpayer must be included in income in the year of receipt. Section 456 thus is the second (section 455 was the first) Congressional acceptance of the deferral of prepaid income principle since that theory was rejected by Congress in 1955 by the repeal of section 452. This creeping corrosion is likely to continue, so that in time the Code may contain the principles of defunct section 452 without the need for general legislation on that point.

Congress was also busy with other proposed legislation relating to accounting methods. The most startling was the Administration's proposal to tax currently to United States shareholders of controlled foreign corporations the earnings of such foreign corporations. This proposal was so convincingly attacked by American business that the Treasury submitted as a substitute a watered-down draft of proposed "tax haven" legislation. The Ways and Means Committee promptly announced that the substitute draft raised certain problems which should be studied further. Accordingly, the latest version of the "tax haven" proposals was not included in the Discussion Draft of the Revenue Bill of 1961 issued by the Committee on August 24 for information of the public.

In connection with the proposal to tax gain on certain depreciable property at ordinary income rates, a Ways and Means Committee release of July 11 indicated that taxpayers would be given the right to change their methods of computing depreciation *without the consent of Treasury,* if that ordinary income proposal went into effect. This provision appears as section 7 (e) of the

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discussion draft, where it is made clear that the right would apply to depreciation on personal property other than livestock.

Numerous bills were introduced in Congress to change other present tax accounting principles but none is considered likely to be enacted in the 87th Congress without Treasury support. Among such bills are those to permit the averaging of income by individuals and the use of several different types of accelerated depreciation.

Treasury and IRS Doings

The most pleasing development of the year to many taxpayers was Treasury Decision 6539. Published in January (on Inauguration Day), it prescribed final regulations under the dollar-value LIFO method of inventory valuation, and provided for the use of a single "pool" for any natural business unit. This is a major concession to the one-pool advocates who have been seeking such a rule for many years. The regulations also permit a taxpayer to change from another LIFO method (such as the unit method) to the dollar-value LIFO method without permission, provided the same pools are used in the dollar-value method as were used in the old method. This is somewhat surprising in view of the Government's 1960 victory in *Harmon Manufacturing Company*, 34 T.C. 316, where the Tax Court held that a change from the unit LIFO method to the dollar-value LIFO method requires advance approval of the Commissioner. True, in *Harmon* there was a change in the number of pools, but the Court did not base its decision on that point.

Other significant final regulations published during the year and relating to tax accounting were those under section 1.381 (c) (6)–1, relating to carryover of depreciation method in certain corporate acquisitions, and under section 1.381 (c) (8)–1, relating to carryover of installment method of accounting. Both of these regulations indicate that, notwithstanding the carryover requirement of the statute, the Commissioner will entertain applications under section 1.446–1 (e) to use another method of accounting.

Considerable concern was created by Rev. Rul. 61–7, which provides that taxpayers who accrue on their books one-twelfth of a property or other tax each month over the period of time covered by the assessment are deemed to be on the ratable accrual method and will not be permitted a deduction of more than twelve months' taxes in their calendar year. This has the effect of denying to many taxpayers the double deduction for real property taxes to which they thought they were entitled in cases where the accrual

date for the tax was advanced by action of the taxing jurisdiction taken before January 1, 1961. (Public Law 86–781 added section 461(d) to the Code to specifically prohibit the double deduction where the advancement occurs on or after such date.) A group from the AICPA protested this revenue ruling and held a conference with IRS officials, but at last word the Service was planning to hold firm to its position unless forced to change as a result of several cases currently in litigation involving this issue. The principal arguments against the revenue ruling are that (1) a monthly accrual per books does not constitute an election under the ratable accrual provisions of section 461(c), because the regulations under that section require a formal election on the income tax return, and (2) where the period covered by the tax coincides with the taxpayer's fiscal year, the monthly accrual method reaches the same result as accrual on a specific date, and only the final result of a taxpayer's accounting method, not the interim means of reaching it, should be considered in determining what the method is.

On the administrative front the Treasury, on May 9, 1961, issued Form 3115 for taxpayers' use in applying for changes in method of accounting. The new form requires detailed information relating to the old method, new method, results of operations for the five preceding years, reasons for requesting the change, etc. Its proper use should eliminate much of the "additional information" letter writing necessary in connection with letter applications, with a concomitant speeding up of the ruling process. In Treasury Decision 6584, issued in late December, 1961, the Regulations were amended to make the use of Form 3115 mandatory.

In Technical Information Release 317, issued May 5, the Commissioner announced that examining officers have been instructed to place increased emphasis on examination of tax returns involving inventories and to give particular attention to inventory reserves, valuation methods, omission of inventory items, and allocation of costs. These elements are all vital in any method of accounting involving inventories, and the announcement is another indication that the Service intends to devote increased attention to methods of accounting in the future. This intention was further emphasized by the addition of five new questions regarding inventory to the principal income tax forms for 1961, plus a requirement in the instructions that the taxpayer provide an explanation of the method used in determining market value when such value is pertinent.

The Commissioner and the Chief Counsel announced in Technical Information Release 288 on January 13, 1961, that the Service has adopted a number of internal operating procedural changes aimed at expediting the issuance of regulations, rulings (including applications for permission to change methods of accounting or accounting periods), and other technical items. The results of these changes are already evident, and an unofficial IRS estimate is that by the end of 1961 the Service will have completed action on all applications for permission to change accounting periods or methods for the 1961 calendar year and prior fiscal periods. If this goal is accomplished, it will indeed be a remarkable improvement, and may be attributed in large part to the reorganization of the Corporation Tax Rulings Branch and the assignment of a larger number of technically qualified personnel to work on accounting period and accounting method applications.

On October 11 the White House announced that new depreciation lives have been established for textile machinery. The White House release stated that other sectors of industry are being studied with a view to determining whether adjustments are necessary in other depreciable lives. On December 6, 1961, a Treasury Department release announced that the IRS will undertake special engineering studies of six major industries as part of the Department's review of depreciation schedules for all industries. The six industries are: Aircraft and parts manufacturers; automobile manufacturers; electrical machinery and equipment manufacturers; metal working machinery and machine tools; steel mills; and railroads. The Treasury expects to announce revised depreciation schedules for major assets for all industries by the Spring of 1962.

In Technical Information Release 350, dated December 18, 1961, the IRS announced the details of the changes applicable to the textile depreciation revisions. Those changes are effective for returns due to be filed after October 11, 1961, not including any extensions of time.

The issuance of the first release by the White House, instead of Treasury or IRS, raised some eyebrows as to the purpose of the release. However, it *is* a step in the way of depreciation reform and is regarded by many taxpayers as a hopeful sign.

Judicial Action

The courts handed down numerous decisions involving tax accounting issues during 1961, in addition to the *American Automobile Association* case previously discussed.

In a case involving the determination of the proper year of accrual and deduction of certain contested real property taxes, the Supreme Court held that the contested portion of the taxes did not accrue in the year in which remittance was made in order to avoid seizure and sale of the property, but in the later year in which the contest was finally resolved. It was not until that year that "all the events" [section 1.461-1 (a) (2)] occurred which fixed the taxpayer's liability. (*Consolidated Edison Company*, decided May 22, 1961.) In that case the Government contended that actual payment of the contested portion of the taxes constituted an admission of liability, but the Court rejected that argument because the taxpayer had protested the disputed amount, and thus characterized payment of such amount as a "deposit."

In the case of *Rosalie Schubert*, 286 F. (2d) 573, affirming 33 T.C. 1048, the Fourth Circuit denied depreciation deductions to a life beneficiary of a testamentary trust because she had no present interest in the depreciable property. Her only interest was in a life estate in improved real property subject to a long-term lease, plus an unencumbered life estate in the depreciable property which could come into existence, taxwise, only upon termination of the lease, at which time she could claim title and possession. The Supreme Court denied certiorari on June 19.

In another action on the "year of deduction" issue, the Supreme Court also denied certiorari on June 19 in the case of *Fifth Avenue Coach Lines, Inc.*, 281 F. (2d) 556. In that case the Second Circuit had held that the taxpayer could not deduct retroactive wage increases in the year the services were rendered because the increase was not determined until the following year when arbitration proceedings were completed. All the events which determined the liability to pay had not occurred in the years to which the retroactive wages related, since the taxpayer had been actively contesting union demands for wage increases. The Court also rested its decision on the principle that no accrual could have been made in the earlier years because the evidence was insufficient to demonstrate that the proper accruals could have been determined with reasonable accuracy.

In the *Fifth Avenue Coach Lines* case the Court of Appeals also denied the taxpayer the right to accrue the interest payable on deficiencies which were determined in principle by a Tax Court decision which was still appealable. The taxpayer, on December 30, 1948, had paid deficiencies and interest for the years 1937 to 1942, pursuant to a Tax Court decision entered December 22,

1948. Deficiencies for the years, 1943 to 1947, due under the same principles as those for the earlier years were not paid but the taxpayer accrued on its books and deducted on its 1948 return interest on such deficiencies in the amount of $109,802.30.

The Tax Court had allowed the deduction of the accrued interest in the 1948 return on the theory that it was extremely unlikely that the decision causing the deficiencies would be appealed. The Second Circuit Court, however, held against the taxpayer because the taxpayer had a right to appeal the decision until March 22, 1949, and had not, by December 31, 1948, relinquished its right to appeal by notifying the Commissioner of acquiescence (presumably by submitting a Form 870 agreement to the deficiencies).

In *Anderson*, T.C. Memo. 1961-139, the Court decided that $500,000 out of a selling price of over $4,000,000 for stock of a corporation was not includible in the income of the cash-method seller in the year of sale. The basis for this holding was that the half-million dollars placed in escrow under the terms of the sales agreement to protect the purchaser against possible breaches of warranty and also as security for the performance and discharge of the obligations and liabilities of the sellers did not unqualifiedly belong to the sellers. There was a possibility that the sellers might never receive the amount in escrow, plus the very realistic circumstance that at the time of trial the money was still in escrow.

In what may turn out to be a Pyrrhic victory, the Commissioner prevailed in the case of *The O. Liquidating Corporation*, CA-3, June 14, 1961, cert. den. Nov. 6, 1961. In that case the Court held that an accrual method taxpayer could not change its clearly erroneous method of accounting for insurance dividends (a material item) without first securing the Commissioner's consent, which was not done, even though the change would result in their accrual in the proper year under the accrual method of accounting. The Commissioner did not contest the lower court's determination that the taxpayer's method of accounting for insurance dividends was incorrect, but argued that permission for a change in the method of accounting for a material item is necessary so that terms can be established to prevent a distortion of income to the detriment of the Government.

This case may provide ammunition for taxpayers in the current unsettled controversy (discussed later) as to whether a change in the treatment of an item is a change in method of accounting, bringing into play the pre-1954 cutoff benefits of section 481, or

whether the change is merely the correction of an error. For in this case the taxpayer had argued that correction of an error to conform to a long-standing method of accounting is not a change in accounting method, and the Commissioner may not require the taxpayer to perpetuate an error. Having made his counter-argument and prevailed, it may now be more difficult for the Commissioner to argue successfully that correction of an error to conform to a long-standing method of accounting is *not* a change in method of accounting.

In *Wright Contracting Company*, 37 T.C. No. 65, decided sixteen days after the Court of Appeals decision in *The O. Liquidating Corporation*, the Tax Court upheld the Commissioner, and denied a change in method of reporting an income item made by the taxpayer without prior approval of the Commissioner. In this case, the Tax Court held that the old method of reporting the "retainage" withheld by customers as income in the year the contracts were completed clearly reflected income

However, in *American Can Company* 37 T.C. No. 26, the Tax Court ruled that the correction of errors in the dates for accruing vacation pay and certain state property taxes did not constitute a change in accounting method requiring Treasury permission. In this case, the Treasury had stipulated that the items in question "accrued" in the year the taxpayer sought to deduct them.

The three cases last discussed relating to changes in accounting method were decided under the 1939 Code. As the *American Can Company* opinion points out, the conclusions might be different under the 1954 Code, currently in effect.

Two recent cases involving an election to use the installment method of accounting have been decided in favor of the taxpayers. In *J. L. Nunn*, D. C. Ky., July 25, 1961, the Court decided that an election was timely when it was made in the year after the sale, which was also the first year in which payments had been received on the note taken in full payment for the land sold. The Court relied in part on *Hornberger*, 289 F. (2d) 603 (May 15, 1961), in which the Fifth Circuit Court allowed the installment method even though a timely election had not been made on the original return for the year of sale. The failure to elect was "excusable" because the accountant who prepared the taxpayer's return erred, and the error may be corrected if the year of sale is still open to adjustment under the statute and if the transaction has not been treated in an inconsistent manner.

The provisions of section 1.453-8 of the regulations, which became effective late in 1958, contain detailed rules and should be considered carefully before too much reliance is placed on the foregoing installment method cases. In *Hornberger* and *Nunn* the courts were dealing with 1939 Code cases, and the 1939 Code regulations on installment method elections were not explicit.

Another case decided recently in favor of the taxpayer is *Bayley*, 35 T.C. 288 (A), where the taxpayer originally reported the sale of his residence as a nontaxable section 1034 transaction but was allowed to amend his petition to elect the installment method if the section 1034 contention was denied. The Treasury has acquiesced in this decision, which represents only a minor departure from the procedure permitted by Rev. Rul. 56-396 (C.B. 1956-2, 298) in a case where a taxpayer reports a sale of his property but contends unsuccessfully that the Code provides for nonrecognition of the gain.

The Eighth Circuit Court has joined in support of the Commissioner on the prior-permission-to-change issue. In *Ekberg*, 291 F. (2d) 913, it was held that a taxpayer using the unit-livestock-price method of inventory valuation improperly attempted to remove his breeding stock from inventory and to depreciate the cost basis of each animal to zero in trying to recover his unit values. This amounted to a change in accounting method which required prior approval of the Commissioner.

The Government's victory in *Ekberg* is not limited to the mere reaffirmation of the well-established rule that prior permission is necessary for a change in method of accounting. The Court also upheld the validity of section 1.471-6 (f) of the regulations, which requires a taxpayer who elects to use the unit-livestock-price method of inventory valuation to apply it to *all* livestock raised, whether for sale or for draft, breeding, or dairy purposes. The taxpayer had relied in part on the case of *Scofield v. Lewis*, 251 F. (2d) 128, where the Fifth Circuit Court had held section 29.22 (c)-6 of Regulations 111, a predecessor of section 1.471-6 (f), to be invalid. *Ekberg* now undoubtedly gives the Treasury new heart. The taxpayer's petition to the Supreme Court for certiorari was denied on November 20, 1961.

In *Reineman v. U. S.*, D. C., N. D. Illinois, March 13, 1961, on appeal, the taxpayer was allowed to deduct a full year's depreciation on December 31 of each year for brood mares purchased each year, where this practice was consistently followed and was one imposed by the custom of the industry, which dictates that all thoroughbred horses are arbitrarily aged 1 year on

December 31, regardless of actual birth date. One might speculate whether this equine equation could not just as successfully be applied to all depreciable property in order to avoid many of the mid-year purchase depreciation problems.

In *South Lake Farms, Inc.*, 36 T.C. No. 106, the taxpayer won a notable victory. There the taxpayer was a farming corporation computing taxable income on the accrual method and reporting on the basis of an April 30 fiscal year. Crops unharvested at the end of each year were not inventoried or otherwise included in gross income until the following year when they were harvested.

The taxpayer's shareholders sold all their stock to an unrelated corporation, which liquidated the taxpayer under section 334 (b) (2). Land preparation expenses of the taxpayer in its final year were $215,000 and expenses of planting and growing crops were $497,000. The Commissioner attempted to increase the income of the taxpayer in its final year by $1,800,000, the value of the unharvested crop and land preparation. An alternative contention was that the income of the taxpayer for its final year should be increased by $712,000, the amount of land preparation and growing expenses.

Judge Withey rejected both of the Commissioner's contentions. One of the arguments advanced by the Commissioner was that section 446 (b) permitted him to ignore the accrual method in the final year because that method did not clearly reflect income in that year. The Court cited its earlier decision in *SoRelle*, 22 T.C. 459, where in a similar factual situation it had denied the Commissioner's right to include the value of an unharvested crop in income when the crop was transferred to the taxpayer's children.

The Commissioner's second argument was that section 482 permitted him to allocate the land and crop preparation expenses to the purchasing corporation in the form of basis, but the Court rejected this also. The principles of section 482 require an allowance somewhere else of a disallowed deduction, reasoned the Court, and the allocation to the purchasing corporation of a deduction to which it is already entitled under section 334 (b) (2) is nothing but a mere disallowance.

The importance of keeping book and tax accounts compatible was emphasized by the Tax Court in the case of *Colorado County Federal Savings and Loan Association*, 36 T.C. No. 118, where the taxpayer was denied an addition to the reserve for bad debts because the addition had not in fact been credited to a specific reserve on the books.

General

One of the main accounting-method controversies continues to center on the relationship of section 481, relating to adjustments required on change of accounting method, to section 1311, relating to correction of an error, and which, if either, of these sections (or perhaps both) is applicable when either the taxpayer or the Commissioner changes the treatment of an item for tax purposes. The issue often arises in connection with the method of valuing inventories, and relates to whether a "change" required by the Commissioner is a change in method of accounting bringing into play the pre-1954 tax-benefit provisions of section 481, or is merely the correction of an error which may involve the application of sections 1311–1315.

Examining officers have been reluctant to classify their changes as section 481 changes because of the tax-free benefits available with respect to the portion of the section 481 adjustment attributable to pre-1954 Code years. Taxpayers have been just as reluctant to accept this attitude, especially in the light of the strict Treasury regulations, which suggest that a change in the treatment of *any* item is a change in method of accounting which requires prior approval of the Commissioner (sections 1.446–1 (e) and 1.471–2). Some taxpayers have asked for the matter to be sent to the IRS National Office for technical advice, and that is where the issue is currently under consideration (and has been for almost two years). It is expected that a helpful clarification of this abstruse issue will be forthcoming soon.

Other accounting-method news in the near future should include action by the Congress on the proposed 8 per cent business investment credit, and, it is hoped, some further affirmative action by Treasury and Congress to implement the tax depreciation reforms sought by so many.

Some Aspects of Investment Planning for European Operations

By Adolf J. H. Enthoven

The U. S. Government has proposed a new foreign trade policy, particularly with respect to the European Common Market. By lowering tariffs between the trading partners, the aim of this policy would be to increase U. S. exports, and to increase trade and competition between the countries in the interest of a strong Western world. For this purpose greater trade liberalization is essential.

A further aim of the foreign trade proposals is to reduce the trend towards setting up production facilities abroad by U. S. companies. The general view is that U. S. companies have set up these facilities to be inside the "tariff wall," and that once tariffs are reduced or even eliminated (in a sort of Atlantic Economic Community), this outflow would cease. The lowering of tariff barriers would, however, increase the competitive pressure, and in consequence generate product developments along lines of comparative advantage. In addition, the highly desired domestic productivity increases would be stimulated, and rapid economic growth would be spurred.

To assume that tariffs are the only or even the most important determinant in setting up facilities abroad is highly misleading. Proximity to the rapidly growing European market and its lower production costs are considered equally important factors, and it is unlikely that their importance will diminish in the near future. No great slowdown is expected in the European boom, and in the trend towards "going abroad." It is hoped, however, that investments will become a two-way street, but much depends upon the U. S. rate of growth and productivity, i.e., our own economic climate.

Private industry has the function of maximizing its return on investment and sales; this "optimization" will not only aid the industry concerned, but also its whole economic sphere.

It is in the light of industry's objective to obtain a greater share of the expanding European markets and to increase its investment/sales return that some aspects in planning European operations are here reviewed.

Any direct investment decision is dependent upon a number of general and specific interdependent factors. A proper aware-

ness of some of these "climatological" factors is becoming of vital concern to corporate executives and planners.

General Economic Developments

European Integration

The economic integration of Western Europe in the form of the Common Market, with its corollary of political unification, is gradually taking shape. The European Coal and Steel Community, set up in 1952, might be considered the "take-off" point for the Common Market; it established a unified market for coal and steel among the six member countries: France, W. Germany, Italy, Belgium, The Netherlands and Luxembourg.

The object of the European Economic Community is economic, social and political unification. It would establish a common market without internal tariffs and with common external tariffs, free movement of capital and labor, and harmonization of economic, fiscal, financial and social policies. Its philosophy is free trade, not protectionism.

For purely economic reasons it is desired to create a production entity, in which mass production and economies of scale would be feasible. The ability to produce for a wide mass market at the

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lowest production costs would result in an increased standard of living for the 170 million people of the EEC. And if all EFTA members (the European Free Trade Association) joined the community it would create a market of 260 million people.

EFTA has a less far-reaching program: the elimination of internal tariffs between the member countries—without establishing a common external tariff—was formerly its principal economic goal!

Past attempts to bridge the aims of the "Inner Six" and "Outer Seven" have been unsuccessful, principally due to differences in outlook on eco-political integration. The U. K. has shied away from a supra-national authority—and its agricultural problem and its preferential tariffs for members of the Commonwealth have posed special obstacles. However, the U. K. seems to be convinced that its economic future is tied to that of Europe, and its decision to apply for membership in the Common Market is a positive step in a new direction. Denmark, and Ireland have followed the U. K. and Norway is likely to follow; Switzerland, Sweden, Portugal and Austria are expected to apply for associate membership.

This widening of the European Economic Community—with Greece and the possible inclusion of Turkey—would have a profound economic and political influence in Europe. The stabilizing and unifying impact of the U. K.'s participation in the Common Market is not to be underestimated.

In addition, it would be easier to adopt a more liberal trade policy in a wider EEC, as competition from new members and associates would partly nullify the aim of a common external tariff.

It is hoped that for the economic progress of the free world, the U. S., Canada and other countries would join a trading alliance with Western Europe. The U. S. participation in the OECD might be a first step in this direction.

Changing Trade and Growth Patterns

The existence of integrated economic groups in Western Europe has considerably changed intra-regional trade during the past years. Trade with the EEC increased by more than 50% between 1958 and 1960; for the EFTA countries this figure was 20%.

There also has been increased trade between EEC and EFTA, principally due to the expansion of EEC exports to EFTA. In the EEC a favorable balance of trade has resulted.

One of the remarkable characteristics of Britain's foreign trade has been a reorientation in favor of Western Europe, at the expense of the Commonwealth.

The growth of the gross national product of the EEC countries increased during 1960 to 7% over 1959, with Germany and The Netherlands leading with an increase of 8%. The U. S. rate of growth was less than 3%. (All in constant prices.) The comparable EFTA rate was 4.8% with the U. K. showing an increase of 4.3%.

Industrial production in the Common Market countries has increased by about 12%, compared with a rate of just over 6% for EFTA. If the different rates of expansion continue, the standard of living in the EEC countries will draw ahead of that in other European countries. The British Government stressed this factor of economic growth as one of the main reasons why the U. K. should seek a close relationship with the EEC.

Implications for the U. S.

U. S. manufacturers—under pressure of stiffer competition—have set up facilities in Western Europe to exploit European and other world markets, which can be more economically supplied from European bases.

The Common Market countries produce at an average of 15% below comparable U. S. product costs, as shown by a recent National Industrial Conference Board Survey. The lower wage and salary unit costs invariably account for the difference between manufacturing costs in the U. S. and the EEC. The relatively high material unit costs in Europe have kept down the disparity in over-all unit costs. However, the rapid industrialization in Europe with mass markets to serve, the ability to produce and market according to economies of scale, the adoption of the latest techniques and the general sense of innovation, probably will greatly increase the rate of productivity development, and widen the production cost gap even more.

The European market is less saturated than our own domestic market, and the U. S. should be able to enjoy the benefits of participation in the rapid progress of the European Economic Community, where mass production is becoming the order of the day. The innovations, the combinations and mergers taking place in the European economies are changing the picture considerably. U. S. know-how and enterprise should be able to bear fruits in this area.

In the long run, the higher standard of living, which might approximate ours in the next 15 years, and the "Americanization" of Europe could lead to increased opportunities for export of capital equipment, tools, mass consumer products and raw materials to foreign and U. S.-owned subsidiary companies in this area.

In a wider, more liberalized North Atlantic market, the combination of foreign-based operations with increased export markets will probably materialize. However, imports could increase at an even faster pace. As for the U. S., less than 4% of its gross national product is exported, compared with Germany's 25% and the Netherlands' 40%.

The U. S., in order to secure a desirable relationship between its foreign investments and export-import balance, might need, above all, various public and private measures to enhance its efficiency, productivity and competitiveness. Fiscal and monetary policy, labor policy, anti-trust legislation, accounting principles and the application of better management techniques are some areas in which improvement is desirable to enhance a higher rate of productivity increase and economic growth.

Forms of Operation

The European market can be penetrated by means of exports, branch operations, foreign licensing agreements and wholly or partly owned subsidiary companies, or a combination of any of these.

Exporting, as a means of obtaining the optimum possible share of the foreign markets, has its limitations due to such factors as production costs, tariff barriers and the specific demands of European customers. Although the absolute volume of our exports has been steadily increasing, their relative share of total foreign sales of U. S.-controlled factories or branches has been declining, and probably will decline even more. Sales, service and assembling branches, the latter especially in free port areas, have been a valuable method of obtaining a "feel" of the market. They have often functioned as a first step towards major investments.

The ability to enhance our export volume to the EEC will largely depend upon our ability to exploit our comparative advantages (especially productivity) and on U. S.-European trade policy.

Licensing Agreements

The place of foreign licensing should be seen in the light of alternative possibilities. There appears to be a tendency to indulge

too easily in this form of operation—at the expense of long-range benefits—due to ease of functioning and minimum capital requirements.

Licensing might not be able to produce the maximum earnings potential, nor a maximum share of the local market. Moreover, the possible loss of know-how and the likelihood of creating competitors are major disadvantages. Poor licensees might do great harm to the licensor's name; good licensees might often improve upon the product for their own use. If the U. S. company is involved in continuous research and product development, the possible loss of know-how to the foreign licensee at the end of the contract of course would be reduced.

However, for small companies with limited resources and outlets, licensing might be the favored solution. The opportunity for cross-licensing should also be investigated, as it might create a closer working relationship and greater protection for the parties involved. In all cases, a good contract is desirable and consultation with a local attorney might prevent some of the licensing pitfalls.

In negotiating licensing agreements, it is worth investigating whether the licensor can obtain an option to purchase stock of the licensee as part of the royalty payments. Many European licensing agreements have functioned as stepping stones towards equity participation. This equity involvement, paving the way for joint ventures, might result in more effective control over operations, greater financial returns, opportunity to share in the company's expansion, and might ensure the continuity of the arrangement. Also, it would inspire greater trust among the respective parties.

Many small and medium-sized European companies, influenced by the new competitive forces and the need for expansion, are eager to enter into licensing agreements with U. S. Companies. Usually no government restrictions are encountered in the legal applications of U. S. companies for such agreements and for transfers of royalties.

Joint Participations

In the past, European firms were seldom enthusiastic about sharing equity with outsiders. Many of these firms were held by a small group of shareholders exercising control. They favored licensing agreements as the means of enabling them to remain independent and, at the same time, to obtain U. S. know-how. Competitive factors and huge outlays of capital for new developments have gradually changed this attitude. There is a growing

awareness that U. S. investments and particularly U. S. know-how, in combination with European interests would be mutually beneficial in the expanding and changing market structure.

At present, joint company concepts are favored in Europe. U. S. firms might enter into joint venture agreements with an existing company, or might form entirely new entities. This latter form of organization is of principal interest as it affords means of protecting the parties from certain "hidden" risks.

Joint participations of American and European interests—majority, minority or equal split—would make it easier to obtain and retain greater knowledge of local conditions and contacts, counteract possible nationalistic feelings and assure a management aware of local customs. Local partners can often arrange tax advantages, and special government concessions. Credit might also be more easily available from local financial sources. Aside from these factors, the sharing of business risks with local shareholders and the sharing of existing facilities for sales, marketing and distribution offer great advantages for U. S. companies whose capital outlays are thus minimized.

The experiences of U. S. firms who have had 50–50 joint-venture agreements with European firms have been generally favorable. However, problems naturally have been encountered. These arise principally from deadlocks in management policy, and in financial policy over questions such as the ploughing back of earnings versus distribution of dividends. It has been possible to make 50–50 ventures workable by transferring 1% of each owner's share to an impartial third party who has the right to consult outsiders or to determine, in case of a deadlock, which party's position shall prevail. In several instances a joint venture has succeeded by the device of one partner's having 49% interest in the production company and 51% in the sales organization.

As the U. S. partner in a joint venture often assumes responsibility for the operations and brings in the technical and commercial know-how, it may seek to retain control by having a majority of the voting stock. Good financial control often can be exercised by stating in the contract that the company audits shall be handled by accounting firms of international standing.

Acquiring Existing Companies

Many U. S. companies have entered the European market by acquiring—wholly or partially—an existing company or plant.

When competition is an important factor, and when it would be difficult to build and operate facilities, as it is at present in Europe due to the shortage of labor, acquiring or merging with a local company might be profitable. The existing marketing, management and production facilities of the acquired company might also be of important competitive advantage.

Acquisitions by U. S. companies have been in the form of outright purchase, exchange of parent company stock, or in case of a minority interest in the firm, the issuance of stock to the U. S. company in exchange for know-how.

It has recently become extremely difficult to obtain a well-run company, since in this period of prosperity few such firms are in need of selling out. Furthermore, these companies have little problem in attracting capital for expansion or modernization. In addition, the competitive struggle, the desire for product integration and the need for scale production have given a tremendous spurt towards mergers in the EEC area, and consequently have made acquisitions more difficult.

Although potential acquistion possibilities still present themselves, many other companies that might be available are often closely held, run-down family companies, or marginal firms with no future in the new market, where tariffs and subsidies will be gradually eliminated. For "conversion" purposes, these facilities might have a future, but should not be purchased until a thorough technical investigation has been made.

A major problem is the question of the "value" of an existing company, for neither the capitalization of "earnings" nor the financial records are a reliable base. In several countries "earnings" are "fiscal earnings," and do not reflect the actual income of the company. The financial statements are often next to worthless; in several countries accounting principles and auditing standards are barely existent, and "certification" of the accounts by a local firm is not to be compared with the certification of financial statements by a U. S. or international accounting firm. In several instances additional financial and fiscal burdens have fallen upon the new owners, who were not aware of certain liabilities. It is, therefore, essential to investigate thoroughly before an investment is made.

The complaint that U. S. firms are trying to swallow up certain economic sectors has seldom been heard in Europe, and the political implications of acquisition of European companies by U. S. concerns has been nil.

Establishing Own Facilities

The economic (and political) stability and progress in Europe has spurred many medium and large-size U. S. companies to set up their own manufacturing organizations in the area. Many of these plants not only are producing for the local market, but also taking care of other areas to which the U. S. parent company exported before.

In relation to the other forms of operation, setting up one's own facilities gives greater protection of know-how, complete managerial, financial and technical control over operations, and reduces meddling by local shareholders.

The disadvantages are, however, the lapse of time before the plant is operational, the scale of production necessary to make operations profitable, the setting up of marketing and distribution channels and the unfamiliarity with business methods in the various countries. In addition, the labor shortage existing in industrial areas (e.g., in Germany and Holland) has become an impeding factor. While licensing agreements and joint ventures often are determined by the skills and capacities of the licensee or partner, the establishment of own facilities will be primarily influenced by general economic, national or regional factors, such as: labor costs and skills, transportation costs, infra-structure facilities, market location, raw materials supply, finance sources, taxation, and government incentives. The evaluation of these factors into a scheme of priorities can be very time-consuming.

Most European countries also have special development areas, which grant new industries special tax, financial or other economic benefits (e.g., plant sites). These incentives are mostly for a limited period, and their short-range benefits might be outweighed by the long-run disadvantages.

Some American firms have encountered problems in adjusting themselves to local conditions and business methods. The U. S. parent company, in setting directions, is often to blame for this. On the other hand, European personnel have often been reluctant to adopt progressive methods and systems.

Financing Possibilities

Almost all companies to be involved in Common Market operations will get involved somehow in the financial aspects of their business activities. Each company will have to evaluate carefully the costs of loan versus equity financing, and local versus outside financing.

At present, each country has its own regulations for financing; however, the ultimate goal of European integration is a uniform monetary policy to be achieved through the liberalization and coordination of the money and capital markets of member countries.

Most European commercial banks are wide in scope and, in contrast with U. S. banks, are also occupied with the brokerage and underwriting aspects. They generally are more intensely involved in industrial operations than their U. S. counterparts, especially in Germany. American companies will usually find a welcome money market in Europe.

European banks, usually are very flexible in suiting credit agreements to customers' needs. Close cooperation exists as a rule between the commercial banks and institutional investors, so that the short-run parts are financed by the banks, and the long-run period of credit by the institutional investors.

Special long-term loans at low interest rates can be obtained for certain designated development areas, in addition to subsidies and other incentives granted for developing new sites.

The various forms of bank finance generally available are:

Current finance, for financing short-term assets. Collateral is usually provided by transferring to the banks: accounts receivable, securities, claims, consignments or a guarantee from the parent company. The banks have no uniform prime lending rate for customers; interest charges usually have to be negotiated. European banks seldom grant unsecured credit loans, except to large customers. Instalment credit institutions have become very active recently, financing also producer goods.

Export credits, by way of private, semi-private or government institutions, are relatively easy to obtain, and this form of financing has grown under pressure of competitive conditions. These credits are granted up to a period of five years.

Medium-term financing, as a rule, is not so well developed as in the U. S.

Long-term financing is often handled by special finance companies, which assist small and medium-sized companies in raising funds. The loans which these companies make available are often tied to the amount of capital invested. For example, the Herstelbank in The Netherlands does not make loans in excess of 50% of the risk-bearing capital (the fixed assets of the company serve as security). Regular banks will, as a rule, extend the medium or short-term loans.

Mortgage loans are also a common form of financing made available through the intermediary services of the regular banks. In addition to banks, the insurance companies have become very active in supplying medium and long-term loans.

Long-term investment credit is also available through other financial institutions (e.g., investment banks) in which the regular banks often have an interest. These institutions can be contacted through the regular banks.

These investment banks are sometimes partially owned by the Government, which is interested in a harmonious economic development program. Generally, these banks will exercise a certain amount of control over the operations, in exchange for their equity participation (mostly up to 50%). However, valuable advice may be obtained from these banks this way.

Special finance banks—often privately or semi-privately owned—are also willing to provide capital for long-term or equity financing. The French "banques d'affaires" are closely tied to industry, and control large sections of industries.

It is rather unusual for foreign subsidiaries to raise equity capital in the local capital market by floating a stock issue. Newly established foreign subsidiary companies, which are controlled by a U. S. parent company, will find it hard to obtain access to the stock exchanges. Once the company is well established and the parent company's stock listed on the exchange, a capital issue might be undertaken.

Foreign companies have been able to float bond issues in the local markets, and the Swiss banks especially—with low interest rates—have been a favorable source for intra-European financing. Some Swiss-based American holding companies also have been successful in financing their European subsidiaries from the Swiss capital market.

A policy of "self-financing" has dominated most European companies and it is still one of the most frequent forms of financing—much more so than in the U. S., and many major European companies are financially independent. (The corollary of this factor is that many European companies are not so much in need of capital, as of *know-how*.) Self-financing or internal financing is either practiced within the company from various "reserves," or from the parent or associated company's funds. Self-financing is enhanced by the accounting principles or "good business practices" as exercised under European accounting systems, especially because of the liberality of depreciation and other special reserves.

In some European countries it is legal accounting practice to set up depreciation reserves based upon replacement values, although for fiscal purposes they are not yet fully accepted. "Replacement value accounting" has its impact on the actual (real) earnings and the amounts available for distribution, as well as the amounts available for keeping the capital structure intact and for "self-financing."

Special reserves for purposes of expansion often are allowed under the accounting systems, in addition to the regularly prevailing "hidden reserves."

TAX CONSIDERATIONS

In the process of evaluating European operations, tax aspects are a consideration, but their importance is secondary to the recovery of a reasonable return on investment. Tax incentives and tax differentials are only one of the criteria to be considered on entering the Common Market. (Corporate income tax rates in the EEC approximate U. S. rates.)

The tax structures of the various member countries show great differences. Indirect taxes account for about 70% of the total revenue in Italy, 65% in France, 47% in Germany and 40% in The Netherlands. The Southern countries rely more upon indirect taxation (especially turnover taxes) than the Northern countries. There is a tendency in the Netherlands, for example, towards more indirect taxation; a reverse trend is envisaged for France and Italy. A host of various national taxes makes a detailed comparison extremely hard.

Corporate income taxation also varies in the member countries, both as to rates and methods of application, and a straight comparison of rates can be made only with reservations. Taxable income is derived by various approaches; for example, in Germany and France the balance sheet approach is adopted, i.e., the annual increase in net worth after various adjustments. Also, most countries have special investment incentives or additional depreciation allowances, not only to correct certain inflationary price rises, but because fiscal policy, capital formation and economic growth are recognized as being highly interdependent.

Capital gains realized in a business are taxed in member countries as regular income. Special regulations apply in some countries where the gains are reinvested.

The tax treatment for holding companies varies considerably. France and the Benelux countries have special reduced levies on profits which are earned and taxed abroad. Switzerland, not a member of the Market, has entered into tax treaty arrangements with the EEC countries, which make it a desirable location for holding companies. All member countries except Luxembourg have treaties with each other and with the U. S. for the avoidance of double taxation.

The harmonization and coordination of the various tax systems, especially indirect taxes, will gradually become a necessity in an integrated market. Since direct taxes, especially income taxes, involve social, political and psychological considerations, these are harder to harmonize. The Commission can only deal

with direct taxation where it threatens to distort competitive conditions.

Tax, financial and economic questions are closely linked, and the Commission has set up a special committee to examine how far the existing disparities between the tax systems in the EEC constitute an obstacle to the establishment of a common market, and to see how these disparities can be eliminated. Another task of the Commission is to examine how far competition is distorted or handicapped by differing tax laws. Tax structure differences can influence the flow of trade and location factors within the EEC. For example, a company that decides to establish operations in a country with relatively high direct taxes, would find its export products also heavily taxed in countries which rely mainly upon indirect taxation. The harmonization of existing differences in social insurance costs (and social benefits) is another major stumbling block; these costs account for approximately 60% of the basic wages in Italy and 30% in the Benelux countries.

Articles 95–99 of the Rome Treaty deal with the fiscal provisions. However, they are principally concerned with indirect taxation. The elimination of customs inspection at the Community's internal frontiers inspired the inclusion of articles on the harmonization of sales taxes and other forms of indirect taxation. Indirect taxes often can have the same effect as customs duties, and as such can form a sort of discrimination, which is illegal in the Common Market. The recent example of the Italian Government-owned tobacco monopoly, where the Government reduced by 20% the customs duties on manufactured tobacco produced within the EEC but concurrently increased its fiscal charges, is a case in point. Cigarettes produced by the Italian monopoly escaped the consequences of these measures through a reduction of the ex-factory price.

The EEC Treaty generally leaves unaffected the autonomy of the member states as to fiscal policy. It was realized that each country would not immediately abandon its financial independence, especially regarding direct taxation. The Common Market states still have divergent budgetary needs. Harmonization is a long-range goal, and is dependent upon acceptance by each member state. No compulsion is envisaged in the Treaty with regard to this harmonization. Complete tax unification is not necessary, and the Common Market system could well function on a federal basis.

Closely related to fiscal policy are reporting requirements and accounting principles. These differ so widely among the various

countries that no centralized effort has yet been made to harmonize them. It is realized, however, that greater standardization and unification will eventually be required.

Restrictive Business Practice Legislation

In long-range planning for international operations, it is essential to consider the implications of restrictive business practice legislation in the Common Market. Competent legal counsel should, by all means, be consulted, not only to evaluate the Common Market regulations, but also to assess the impact of U. S. antitrust laws on the foreign operations of American companies.

Under the proposed restrictive business practice regulations in the EEC, cartel agreements and combinations adversely affecting competition would be found objectionable by the Common Market Commission, and would have to be dissolved or amended. Exclusive licensing agreements, which restrict competition within a Common Market country, would possibly also be prohibited under the Articles of the Rome Treaty. In addition, dumping practices would be discontinued. State subsidies would be allowed only under certain conditions, and imported goods from other member countries would be given the same tax treatment as domestic goods.

The proposed regulations emphasize cartel agreements rather than mergers and concentrations, as it is felt that cartels might more easily lead to distorted competitive positions. Existing cartels or combinations which contribute to the improvement of production or distribution of goods or to the promotion of technical or economic progress would be allowed to continue. The size of the company is not the determining factor, and it is realized that technical progress might require certain concentrations. Efficiency is often tied to size, and a properly directed merger can be a vehicle for preserving competition.

The proposed Common Market legislation appears to be rather liberal and takes cognizance of economic developments and necessities.

Changes in Accounting Methods

By William T. Barnes

The practical aspects of administration and the necessity for current collections of revenue by the government require that taxes be ascertained and collected on a yearly basis. Hence, a taxpayer must use some method of accounting to ascribe his lifetime income to annual periods.

Small, newly organized companies frequently do not require elaborate accounting records or systems. It is customary for such a company to minimize expenses during its early years and, as a result, it may not have the benefit of adequate accounting advice. Economic conditions and business practices change and generally accepted accounting principles and practices are themselves subject to continuing refinement and improvement. Even the revenue laws are not immutable.

Thus, for any of a variety of good and sufficient reasons either a taxpayer or the Commissioner may desire a change from the method of accounting adopted. Since the new method will apply a different test to determine the annual period in which items of income and expenses will be reflected, it may involve the duplicate reporting of some items or the complete omission of others.

Thus, to permit a complete change without some adjustment would produce correctly calculated income for the year of the change at the expense of distorting the aggregate income for the taxpayer's entire existence. On the other hand, an adjustment which would prevent the latter would distort income for the year of change and, at least in the case of individuals, would be likely to produce a tax liability far different than if either the old or the new method had been used from the outset. Moreover, the concept of the statute of limitations is that past errors achieve a state of repose after the specified period. The adjustment required to prevent duplications or omissions in many cases contravenes this purpose.

Add to the aforementioned factors the Commissioner's constant concern over any loss of revenue and you have the ingredients of the perplexing problem which has existed almost since the advent of the income tax and which remains unsolved.

History

Early Tax Law

The Revenue Act of 1913 required the reporting of income on the accrual basis.[1] The Revenue Act of 1916 recognized that there were two methods generally in use and permitted the use of the cash method.[2] This change was effected in oblique fashion by the provision that "an individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such basis does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case his tax shall be computed upon his income as so returned."[3] In the light of today's problems, it is interesting to note that the Supreme Court declared in an early case that the "basis of keeping accounts" did not mean the accuracy or propriety of individual items.[4]

In another early case[5] the Board of Tax Appeals started the ball rolling by allowing the Commissioner to disregard opening inventories for the year in which the taxpayer changed from the cash to the accrual method.

It is also interesting to note, in connection with the current controversy about what constitutes a "method of accounting," that the Revenue Acts of 1918 and 1921 provided that, if the

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method of accounting regularly employed by the taxpayer in keeping his books of account did not clearly reflect the income, then the computation should be made "upon such basis and in such manner" as in the opinion of the Commissioner did clearly reflect the income.[6] The above-quoted phrase was replaced in the 1924 Act by the phrase "in accordance with such method"[7] which has remained in the law ever since. The Committee Reports on the 1924 Act give no explanation for the change.

The Law and Regulations Under the 1939 Code

The 1939 Code and regulations, as here pertinent, were couched in very general terms. Each taxpayer was required to make a return of his "true" income and to maintain such accounting records as would enable him to do so.[8] As today, net income was to be computed in accordance with the method of accounting regularly employed in keeping the taxpayer's books provided such method clearly reflected the income.[9] The accrual method was required with regard to purchases and sales where inventories were involved.[10] Reasonable consistency was required.[11] Hybrid methods were not authorized. The Code did not mention changes in methods of accounting, but the regulations defined such a change as "any change in the accounting treatment of items of income or deductions."[12] The Commissioner's permission was required and was contingent upon agreement to the terms and conditions of the change.[13]

Interpretation by Courts

In interpreting the reporting requirements of the 1939 Code, the courts generally recognized the Commissioner's broad powers with respect to permitting or denying a change in method of accounting.[14] He was sustained when he chose to negate ungranted changes in the over-all method[15] as well as changes in the treatment of some items.[16] Hybrid methods were generally unacceptable.[17] Consistency of reporting tended to be determinative of whether an existing method clearly reflected income and this rule was invoked against both taxpayers[18] and the Commissioner[19] in denying the desired change in method. However, consistency had no merit where taxpayers with inventories were erroneously reporting on the cash method.[20] It was these cases in which early decisions went off on the theory of preventing income from escaping taxation and sustained the Commissioner in pyramiding adjustments in the year of change.[21]

After litigation encompassing a period of more than twenty years, the Second Circuit overruled its landmark *Hardy* decision and agreed with some of the earlier cases denying the Commissioner the right to make pyramiding adjustments where he had forced the change in accounting methods.[22] It was recognized that to hold otherwise would circumvent the operation of the statute of limitations. The situation was never completely clarified with respect to taxpayers' voluntary changes, although the weight of authority seemed to favor pyramiding adjustments, particularly in cases involving changes from one correct method to another correct method.[23]

Situation Under the 1954 Code

In view of the confusion which had existed under the 1939 Code with respect to the use of hybrid methods, the proper tax treatment of prepaid income and related expenses, and of changes in methods of accounting, the Congress enacted certain new accounting provisions and expanded existing ones in the 1954 Code.[24] It was announced that the changes were designed to bring the income tax provisions of the law into harmony with generally accepted accounting principles.[25] For the first time, a provision was placed in the Code authorizing the use of one or more hybrid methods of accounting pursuant to regulations to be prescribed by the Secretary or his delegate.[26] Case law permitting different methods of accounting for the several trades or businesses of a taxpayer was codified.[27] The existing regulations were codified to the extent that they required the Commissioner's permission before a change could be made.[28] The Committee Reports indicated that a change in the method of accounting was a substantial change as distinguished from each change in the treatment of each item.[29] Provision was made for relief from the tax burden represented by pyramiding, or transitional, adjustments in the year of change and it was further provided that such adjustments should not include amounts representing errors made prior to 1954.[30]

But these new provisions foundered because of their impact on current government revenues. Sections 452 and 462 were repealed.[31] The Commissioner refused to grant permission to taxpayers to change their accounting methods while he lobbied for a change in the law. Eventually he was successful and in 1958 the law was amended to permit exclusion of adjustments relating to 1939 Code years only where the change in accounting method was

initiated by the Commissioner.[32] Thus, we find ourselves in much the same position as that indicated by the decided cases under the 1939 Code.

EFFECT OF SECTION 481

The major portion of the verbiage in this section is devoted to the mechanical relief provisions which pose no major problems.

Income for the year of the change is computed under the new method of accounting.[33] The net adjustment required to prevent duplications or omissions is determined and divided between the 1939 Code years' portion and the 1954 Code years' portion.[34]

The 1939 Code years' portion is the adjustment which would have been required had the change occurred in taxpayer's first 1954 Code year, but cannot be greater than the total adjustment. The 1939 Code years' adjustment is not taken into account in cases where the change is initiated by the Commissioner.[35]

In cases where the change is initiated by the taxpayer and the 1939 Code years' adjustment increases taxable income by more than \$3,000, relief from the resulting tax burden is provided in the form of a ten-year spreadforward, i.e., one-tenth of the adjustment is taxed in the year of change and in each of the succeeding nine years.[36] Provision is made for acceleration of the deferred portion in the case of the death of an individual, the liquidation of a partner's interest, or the cessation of business activity by a corporation.[37] This relief provision is inapplicable to changes made in years beginning after December 31, 1963.[38]

In the case of a change initiated by the taxpayer where the 1939 Code years' adjustment is a decrease or if it increases taxable income by \$3,000 or less, it is taken into account with the 1954 Code years' adjustment and treated similarly.[39] If the total adjustment is a decrease or if it increases taxable income by \$3,000 or less, the entire amount is taken into account in the year of change. If the total adjustment increases taxable income by more than \$3,000, tax is paid for the year of change but the amount of tax applicable to the adjustment is the least of the following:

(a) The tax attributable to inclusion of the entire amount in the year of change;

(b) The tax attributable to inclusion of the total adjustment ratably in the year of change and the two preceding taxable years; or

(c) The tax attributable to recomputing the taxable income of one or more consecutive preceding years under the new method of accounting and allocating any unaccounted for balance of the total adjustment to the year of change.

These spreadback provisions do not apply unless the taxpayer used the method of accounting from which the change was made in each of the applicable preceding taxable years.[40] A taxpayer may elect to apply these spreadback provisions, instead of the ten-year spreadforward, to the 1939 Code years' portion of the total adjustment as well.[41]

In addition to the methods described above, the adjustments required by section 481 may be made in any manner that may be agreed upon by the Commissioner and the taxpayer.[42]

The regulations make it clear that the term "adjustments" in the case of a change in the over-all method of accounting, such as from the cash to the accrual method, means the consolidation of adjustments, whether increases or decreases in items of income or deductions, arising with respect to balances in various accounts such as inventory, accounts receivable, and accounts payable at the beginning of the year of change. In such a case, the adjustment would also include such otherwise controversial items as vacation pay and state property taxes. It is also clear that it is the net dollar balance which is determined with respect to the portion attributable to pre-1954 Code years and that neither the identity nor the composition of the individual items is material.[43]

What Constitutes a Change in Method of Accounting?

As has been related previously, the 1939 Code contained no reference to a change in method of accounting, although the regulations thereunder defined such a change as *any* change in the accounting treatment of items of income or deductions. The 1954 Code does not define either a method or a change in method but does provide a starting point by providing, under the heading "Permissible Methods,"[44] that a taxpayer may compute taxable income under:

(a) the cash receipts and disbursements method;

(b) an accrual method;

(c) any other method permitted by Chapter 1 of the Code; or

(d) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

The "Material Item" Concept

While not taking issue specifically with the regulations under the 1939 Code, the Committee Reports introduced a qualification by stating that a change in the method of accounting is a *substantial* change as distinguished from *each* change in the treatment of *each* item.[45]

The regulations ostensibly follow this concept by stating that a change in the method of accounting *includes* a change in the over-all method of accounting for gross income and deductions or a change in the treatment of a *material* item.[46] However, a conflict of terms arises because the regulations also define a "method of accounting" as including not only the over-all method of the taxpayer but also the accounting treatment of *any* item.[47] Examples given of changes requiring consent are:

(a) a change from the cash to an accrual method, or vice versa;

(b) a change involving the method or basis used in the valuation of inventories;

(c) a change from the cash or accrual method to a long-term contract method, or vice versa;

(d) a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or

(e) a change in the treatment of any other items of income or expense, *where material*.[48]

Thus, despite the existence of contradictions in the regulations, it seems clear that the IRS has adopted in its regulations the "substantiality" or "material item" concept reflected by the legislative history.

In September, 1959, the IRS issued a ruling[49] in which it held that taxpayers employing the accrual method of accounting who have consistently deducted a material item in the year paid rather than the year accrued must obtain the prior consent of the Commissioner before changing such method of accounting, regardless of whether the taxpayer regards the method from which he desires to change to be proper. This ruling purported to "clarify" two prior rulings,[50] dealing with vacation pay and state property taxes, which had held that a double deduction was not allowable where such deductions had been taken on a cash basis and were being changed to the accrual basis, but that the taxpayers could utilize the mitigation of limitations provisions[51] to prevent the loss of one year's deduction.

It has been argued that the term "method" as used in the Code refers only to a permissible method and that the permission of the Commissioner is not required in cases where the taxpayer is treating an item or items erroneously under the regulations. This argument is stronger for years governed by the 1939 Code, which did not permit hybrid methods of accounting. However, it has some appeal even under the 1954 Code, which authorizes hybrid methods only to the extent permitted under regulations

prescribed by the Commissioner.[52] Although the regulations say that any combination of the cash method, the accrual method, and other special methods authorized elsewhere in the Code will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used, they go on and set certain limits on such combinations. Thus, a taxpayer using an accrual method with respect to purchases and sales may use the cash method with respect to other items, but must use it in computing *all* other items of income and expense. A taxpayer using the cash method in computing gross income from his trade or business must use the *same* method in computing the expenses of such business. A taxpayer using an accrual method in computing business expenses must use the *same* method in computing items affecting gross income from such business.[53]

Accordingly, it is argued that a taxpayer who employs an accrual method in all respects except for one item of expense, such as vacation pay, should not be denied the right to conform his treatment of the item, even if material, to his over-all accrual method. If the right to change should be denied, the taxpayer would be forced to continue a hybrid method which is not authorized by the regulations.

It strikes the author that this argument is misdirected. The Code gives the Commissioner complete regulatory authority in this area. The regulations already provide that the Commissioner may authorize a taxpayer to adopt, change to, or continue a method not specifically authorized by the regulations so long as income is clearly reflected by such method.[54] So long as the Commissioner *in practice* will allow the adoption by new taxpayers of the same hybrid methods which he refuses to allow changed without his permission, it is difficult to fault him under the statute and the regulations. On the other hand, it is the author's opinion that there has been entirely too much emphasis in the IRS on loss of revenue and that conforming changes should be permitted so long as the taxpayer is not choosing the time of change for special advantage.

Conflict between Court Decisions

The courts seem to be divided on the question of conforming an item to the taxpayer's over-all method of accounting. In *O. Liquidating Corporation*[55] the Tax Court concluded that the accrual of dividends receivable with respect to certain group insurance policies in advance of the time such dividends were actu-

ally determined and declared was an erroneous treatment and inconsistent with the method of accounting regularly employed by the taxpayer in keeping its books. The Court held that the correction of this "erroneous treatment" was not a change in method of accounting requiring the Commissioner's permission. The Third Circuit reversed the Tax Court and, in effect, approved the Commissioner's position as set forth in Rev. Rul. 59–285.[56] It should be noted that the taxpayer changed in 1953 the treatment which had been consistently followed since 1941. In *Beacon Publishing Co.*[57] the Tax Court held that the taxpayer could not defer the reporting of prepaid subscription income, applying the "claim of right" doctrine. The Tenth Circuit reversed the Tax Court, holding that the "claim of right" doctrine was inapplicable and, further, that the taxpayer's deferral of prepaid subscriptions in 1943 was merely the application of its over-all accrual method and was not a change requiring the consent of the Commissioner.[58] It is not clear for how long the taxpayer had reported this item of income on a cash basis, but there are indications that such treatment extended back at least to 1928. It should be noted that the Court concluded, in passing, that a taxpayer could not change its method of keeping books without the consent of the Commissioner, even as to items, if the change resulted in "an avoidance of taxes due."

At first, the Tax Court appeared to have accepted its reversal by the Third Circuit in *O. Liquidating Corp.* In *Wright Contracting Co.*,[58a] it upheld the Treasury in requiring the taxpayer to continue reporting "retainage" as income in the year the contracts were completed unless it could obtain the Treasury's permission to change to the more generally used method of deferring such reporting until the related funds were freed of any restrictions.

However, in the very recent case of *American Can Co.*[58b] the Tax Court permitted the correction without the Treasury's permission of long-standing "errors" in the dates for accruing vacation pay and certain state property taxes. With four dissents the Tax Court held that these corrections (which resulted in increased deductions) did not constitute a change of accounting method. The decision may have been influenced by a Treasury stipulation that the items in question "accrued" in the year the taxpayer sought to deduct them.

All the cases discussed above involved the application of the 1939 Code and the regulations thereunder. In the light of the change in the 1954 Code, authorizing the use of hybrid methods

of accounting, it seems reasonable to assume that the rationale of Rev. Rul. 59–285 will be sustained by the courts.

This leads us to the question of what constitutes a "substantial" change of a "material" item. The Third Circuit held in the *O. Liquidating Corporation* case that insurance dividends amounting to $140,000 per year constituted a material item. Although this conclusion cannot be questioned *per se*, it is noted that the Court did not rationalize it by relating the amount to sales, gross income, or net income. Rather, the conclusion apparently was reached on the basis of the absolute number of dollars. This also appears to be the approach which the IRS will take, although no rule-of-thumb amount has been indicated. It must be admitted that a rationale for what is "material" is difficult to achieve in the light of the legislative history indicating that a change in the method of depreciating *any* property (conceivably, a $50 chair) is a change in the treatment of a material item. Also to be considered is the fact that section 481 specifically provides for differences in treatment depending on whether the adjustment required to prevent duplications or omissions is $3,000 or less, or more than $3,000. In view of the foregoing, it is reasonable to assume that the IRS will establish a standard of materiality at a low dollar amount.

Inventory Valuation Cases

Early this year the Commissioner of Internal Revenue, taking his cue from a passage in the President's tax message to Congress, announced that examining personnel had been instructed to place increased emphasis on examination of tax returns involving inventories and to give particular attention to inventory reserves, valuation methods, omission of inventory items, and allocations of costs.[59] It seems certain that extensive litigation will arise as a result of this drive, centering around whether the "iron curtain" of section 481 excludes the 1939 Code years' portion of the adjustments which the IRS may demand.

The legislative history indicates that a change in the "method of valuing" inventory is a change in method of accounting within the meaning of section 481.[60] But there are numerous phases of inventory valuation. The regulations dealing specifically with inventory valuation use the term "method" to describe certain procedures which are unacceptable to the IRS, such as using nominal prices, omitting portions of the inventory, etc.[61] How far beneath the generic system (i.e., first-in, first-out or last-in, first-out) does the "method of valuing" inventory extend? The Tax

Court has held that a change from the unit method to the dollar-value method of LIFO inventory valuation is a change in method of accounting[62] and that the consistent exclusion of supplies and indirect expenses from inventory constitutes a method of accounting.[63] The regulations governing the use of dollar-value LIFO, promulgated after the *Harmon* decision, provide that permission is required to change to dollar-value LIFO except where there is no change in the number of pools, and that permission is required to change the number of pools after the adoption of dollar-value LIFO.[64] The proposed regulations under section 381 (c) (5), dealing with carryovers of inventory methods in certain corporate acquisitions, fragmentize LIFO in one example, into the dollar-value method, the double-extension method, the pool under the natural business unit method, and the method of valuing annual inventory increases by reference to the actual cost of goods most recently purchased.[65] On the other hand, these proposed regulations state, without amplification, that two corporations shall not be considered to be taking inventories on different methods merely because they use "different cost accounting systems in computing the cost of inventories."[66]

It seems clear that direct costing and variations thereof constitute methods of accounting within the meaning of sections 446(e) and 481 even though unacceptable to the IRS. But what about the continued use of long-outmoded standard costs,[67] or the consistent use of an arbitrary $1 per unit as the value of certain items of inventory?[68] These obviously involve "an orderly procedure or process; a regular way or manner of doing anything"—the dictionary definition of the term "method." And the Service, intent on maintaining rigid control on taxpayers' changes, has declared that a change in the treatment of any material item is a change in method of accounting requiring the Commissioner's permission, irrespective of whether the taxpayer regards his existing method to be correct or incorrect.[69] Yet it seems probable that the IRS will attempt to draw the line short of such a broad concept in inventory cases.

What is the likely difference in results depending on whether a "method of accounting" or the "correction of an error" is involved? There is no doubt that in the latter instance the IRS will first attempt to adjust a taxpayer's closing inventory without allowing a corresponding adjustment to his opening inventory. The Service may then retreat to the position of allowing a "roll-back" through the taxable years still open under the statute of

limitations, but denying a corresponding adjustment to the opening inventory of the last previous open year. The decided cases indicate that the Commissioner will be unable to maintain this position[70] but, in addition to sections 1311–1315 which will be discussed later herein, he may have an untried string in his bow in the form of section 1013. This section of the Code, which has virtually no legislative history although a similar provision has been a part of our tax law since 1918, tersely provides that if property should have been included in the last inventory, the basis shall be the last inventory value thereof. The regulations under this section merely paraphrase the statute.

If the Commissioner is unsuccessful in his attempt to pyramid adjustments for the inventory errors of barred years into the last previous open year, the taxpayer will be in a position comparable to that which would exist if section 481 applied to an involuntary change, except that the effect of his "iron curtain" would depend upon the happenstance of how many years are open. In view of the fact that there is nothing in the legislative history of section 481 to indicate that the propriety of either the former or the new method is of any significance, as well as the fact that opening inventories are allowed, subject to a section 481 adjustment, under the regulations where the change is from the cash to the accrual method even though the use of the cash method was patently erroneous,[71] there seems to be no justification for a difference in results due to the nebulous distinction between a "change in method" and the "correction of an error."

Who Has Initiated the Change?

As we have seen, the 1939 Code years' portion of section 481 adjustments is not taken into account unless the change in method of accounting was "initiated" by the taxpayer. The Committee reports state that changes in methods of accounting initiated by the taxpayer include a change which he originates by requesting permission of the Commissioner to change and also cases where a taxpayer shifts from one method of accounting to another without the Commissioner's permission. However, a change "required by a revenue agent upon examination of the taxpayer's return" was not to be considered as a change initiated by the taxpayer.[72] The regulations use slightly different language, saying that a change "required as a result of an examination of the taxpayer's income tax return" will not be considered as initiated by the taxpayer.[73]

Where an Internal Revenue Agent during the course of an examination in 1954 told taxpayers that the law required and it

was necessary for them to change from the cash to the accrual method in keeping books and reporting income a District Court has held that such change made by the taxpayers for the year 1955 was not initiated by the taxpayers within the meaning of section 481.[74] Where an Internal Revenue Agent in 1948 told the taxpayers that it would be a good idea for them to change from the cash to the accrual basis, their subsequent change in 1952 was held by the courts to constitute a voluntary change under the 1939 Code,[75] with the result that pyramiding adjustments were permitted.

Who has "initiated" the change where a taxpayer changes the method of accounting employed in keeping his books but continues to report income for tax purposes under the old method until the District Director forces a conforming change? This question becomes particularly important where the adjustments attributable to 1939 Code years are substantial in amount and where the taxpayer's certified public accountants and/or the Securities and Exchange Commission require that financial statements be prepared on a different basis. While the author doubts that the Commissioner can prevail in the position that a taxpayer-initiated change has occurred under such circumstances, for reasons hereinafter stated, the practical solution is to change the financial statements but not the books. This procedure is acceptable under SEC rules so long as the statements are footnoted to indicate the differences and the accountants' certificate sets them forth.[76]

If the books are changed, it appears that the Commissioner will argue along the following lines: Section 446 (a) requires the taxpayer to report taxable income under the same method of accounting used in keeping his books, but section 446 (e) forbids a change in his tax-accounting method without the Commissioner's consent. When read together, therefore, these two subsections seem to require that the permission of the Commissioner be obtained before a taxpayer can change his business-accounting method. It is clear that a taxpayer who requests permission to change has "initiated" such change within the meaning of section 481. It can be argued, therefore, that a taxpayer who ignores section 446 (a) should not receive more favorable treatment than one who obeys the letter of the law.

This argument depends, of course, on a literal interpretation of the language of section 446 (a) such as that of the Tax Court in the *Patchen* case. There the Court held that a taxpayer who had changed his books from the cash to the accrual basis in 1948

could not report income for tax purposes in 1948 and subsequent years on the cash basis. Inventories were not involved and the Court recognized that either method would clearly reflect income. The Fifth Circuit reversed the Tax Court but unfortunately went off on the tangent that the new system supplemented rather than supplanted the cash method. However, the Circuit Court seems to have held that the requirements of section 446 (a) (then section 41) are met when working papers setting forth the necessary adjusting memorandum journal entries are kept and are readily available to examining officers.[77]

The argument was more squarely met in the *St. Luke's Hospital* case.[78] There the taxpayer received permission from the Commissioner to change from the accrual to the cash method for the year 1953, but did not change its books from the accrual method. Apparently because of a dispute about the meaning of the Commissioner's terms and conditions letter as it related to future collections of accounts receivable, the Commissioner attempted to force the taxpayer to report on the accrual method. The Tax Court squarely rejected the argument that the statutory language regarding conformity between books and tax returns is mandatory.[79]

If conformity between the books and the tax returns is not mandatory with respect to the over-all method of accounting, it certainly would not be required as to individual items except where, as in the case of LIFO inventory valuation, it is specifically stated as a condition for the use of a particular method. Even in that case, the requirement of the regulations[80] goes beyond the statutory requirement which is limited to reports or statements to shareholders, partners, etc., or for credit purposes.[81]

Nevertheless, for as long as the IRS maintains its strict position with respect to conformity, the prudent course of action is to change only the financial statements and not change the books in cases where the 1939 Code years' portion of the section 481 adjustment is substantial and would create additional income. It should be noted that the IRS recently commenced including in letters granting permission to change tax-accounting methods a condition that the books must be correspondingly changed.

Relationship between Section 481 and Sections 1311–1315

Various sections of the Internal Revenue Code prescribe the point in time at which the annual accounting period for tax purposes is closed and the tax liability finalized. As we have seen,

this was an important factor in the court decisions under the 1939 Code in deciding the Commissioner's right to make pyramiding adjustments.

Because these statutes of limitations often can produce hardship either to the taxpayer or the Commissioner, provisions to mitigate such harships were first included in the Revenue Act of 1938.[82] In substance, these provisions permit under specified conditions the correction of errors in years otherwise barred by the statutes of limitations.

It is apparent, therefore, that there is an element of duplication in the functions and effects of section 481 and sections 1311–1315. It is generally agreed, however, that section 481 should prevail in cases of overlap.[83]

The importance of delineating the respective areas of coverage lies in the significant differences in timing and results. Correction of an error through the medium of sections 1311–1315 must await a final determination which creates an inconsistent or contradictory position with respect to an item;[84] there is no "iron curtain" on prior years' adjustments as is the case under section 481 when the Commissioner initiates the change; the tax effect of the correction reflects the marginal rate of the year in which the error occurred and may differ greatly from the tax effect under section 481;[85] and interest is computed on the basis of a deficiency or overpayment for the year of the error whereas the adjustment under section 481 is made in the year of change or, in part, in subsequent years.

Most of the cases in which the IRS has adopted a broad view of what constitutes a change in method of accounting involve situations of so-called double deductions, e.g., property taxes and vacation pay. It is apparent, moreover, that the Commissioner would like to maintain as rigid control as possible over all changes in the treatment of any and all items. But this puts him on the horns of a dilemma in inventory valuation cases where, because of the early origin of the questioned method, the 1939 Code years' portion of a section 481 adjustment is substantial. It is in these cases that the possible application of sections 1311–1315, rather than section 481, is most inviting to the Commissioner.

The circumstances of adjustment set forth in section 1312 include the double inclusion of an item of gross income, the double allowance of a deduction, the double exclusion of an item of gross income, and the double disallowance of a deduction.

It is clear that inventories are not "deductions" in the statutory sense. From time to time there has been a question concerning whether an inventory was an "item of gross income" and, if so, whether there had to be a tracing of the effect on gross income to the original transactions.[86] However, the prevailing view is that the statutory term "item" includes any item or amount which affects gross income in more than one year.[87] Under this view, the correction of an understatement of inventory value would constitute a double exclusion of an item of gross income within the meaning of section 1312 (3) (A).

However, the Code requires that in such a case there be adopted in the determination a position "maintained" by the taxpayer with respect to whom the determination is made and that such position be inconsistent with the previous treatment of the item.[88] It has been held to be of no consequence whose position the error reflects so long as the determination adopts the position of the party (or related taxpayer) seeking to invoke the statute of limitations.[89] But whose "maintained" position is being adopted where the taxpayer's basic position is that the return should not be changed, but his alternative position is that both opening and closing inventories should be adjusted correspondingly?

In *Heer-Andres Investment Company* the Commissioner was sustained in his contention that certain additional rental income, consistently reported by taxpayer in the year of receipt, was properly includible one year earlier, but was denied the right to include both the income received and also the income accrued in taxable income for 1946, the earliest open year.[90] In a later proceeding, the Commissioner was denied the right to invoke the mitigation provisions, the Court referring to the taxpayer's argument against pyramiding adjustments as "its alternative contention."[91]

At issue in the *SoRelle* case[92] was the application of the mitigation provisions to three items. Taxpayer was a farmer and rancher who had consistently (at least since 1939) utilized a hybrid system of accounting, reporting income on the cash basis plus the use of cattle inventories. The taxpayer valued his breeding herd at average actual cost and valued the remainder of his cattle under the farm-price method. He did not inventory his stock of wheat. In an earlier proceeding,[93] the Commissioner accepted taxpayer's hybrid method for 1946, but adjusted the closing inventory of cattle by application of the farm-price method to the entire herd and computed a closing inventory of wheat. The taxpayer challenged his own method of accounting, contending that he should

have used the cash method. In the alternative, taxpayer contended that his opening inventory also should be adjusted to reflect application of the farm-price method to his entire herd and to allow an opening inventory of wheat. The Tax Court disregarded the basic positions of both litigants and determined that the accrual method should be used. As a result of this determination, an adjustment was made which had not been requested by either party, i.e., the elimination from 1946 income of certain cattle sales consummated in December, 1945, for which payment had been received in 1946. The Court accepted the Commissioner's valuation of closing inventories, but held that opening inventories should be adjusted correspondingly.

The Court's decision on the application of the mitigation provisions to 1945 held that, since taxpayer had argued for the use of the cash method, which position was not inconsistent with the exclusion from 1945 income of the cattle sales made in December of that year but not paid for until 1946, the Commissioner could not tax such sales in 1945. However, the Commissioner's right to adjust taxpayer's closing inventories for 1945 was upheld by the Court because it had adopted taxpayer's alternative contention in the prior proceeding. It appears that the taxpayer did not argue the point of primary versus alternative positions, contending only that its opening inventories for the barred year also should be revalued and that section 1312 (3) (B), rather than section 1312 (3) (A), applied to the wheat inventory issue. It is also not clear whether this decision was affected by the fact that taxpayer challenged his own consistently followed method of accounting in the prior proceeding.

It remains to be seen whether the Tax Court will follow its decision in *Heer-Andres* or its decision in *SoRelle* in a future case in which the taxpayer steadfastly defends his consistently followed method of inventory valuation and only secondarily challenges the Commissioner's right to adjust closing inventories without making a corresponding adjustment to opening inventories.

Obtaining Permission to Change Accounting Methods

The Commissioner's permission is not required for a change from the double declining balance method of depreciation to the straight-line method;[94] for a change to the LIFO method of inventory valuation;[95] for a change to the installment method of reporting income;[96] for a change by members of an affiliated group where necessary to clearly reflect consolidated net income;[97] or for

a change from amortization of emergency facilities or grain storage facilities to regular depreciation.[98]

In other cases permission to change must ordinarily be requested by filing an application with the Commissioner within 90 days after the beginning of the taxable year to be affected by the change.[99] Form 3115 recently has been provided for this purpose[100] and requires a description of the change; identification of the taxable year of change; a description of the nature of the business and the principal sources of income; a five-year comparative income statement (or a statement covering the existence of the business if less than five years); the amount and year of origin of net operating loss carryovers available to be carried to the year of change; a description of any previous changes in accounting methods made during the preceding ten years; and a statement of the business reasons for the change.

Revenue considerations control the attitude of the personnel of the Tax Rulings Division of IRS with respect to these applications. It is only fair to state also that tax reduction or deferral considerations are the primary motive for many of the applications to change accounting methods. As a result the stalemate on granting permission to change accounting methods, where more than a trivial loss of immediate revenue was involved, was only partially alleviated following the 1958 amendment of section 481, previously referred to, and the backlog of pending applications continued to mount. For a time following the amendment, it was possible to obtain permission to change from the cash to the accrual method where there were inventories; to change from the specific charge-off method to the reserve method of accounting for bad debts; and to change from immediate recognition of income on discounted loans to a method whereby income was spread over the period of the loan.

Although the backlog of pending applications has now been reduced, largely through denial of permission, the Service attitude is even more revenue-oriented than before. Recent developments include the suggestion that either the bad debts charged off or the addition to the reserve for bad debts during the year of change may be required to be deferred and deducted over some future period, perhaps as much as ten years, and that banks may not be permitted in the future to change completely in one year from immediate recognition of income on discounted loans to recognition of income as earned, but rather might be required to make such a change gradually over a ten-year period. Rev. Rul. 58–340,[101]

permitting accrual-method taxpayers who have been deducting vacation pay on a paid basis to obtain a double deduction without requesting permission in the year in which they adopt a completely vested vacation pay plan, is still effective. This ruling can be distinguished as involving a change of facts rather than a change of accounting method. However, it is not certain that the Treasury agrees with this distinction.

It is the author's opinion that taxpayers who are using a patently incorrect method, e.g., accrual-method taxpayers deducting a material item or items on a paid basis, should be permitted to change their methods without the necessity for advancing a business reason so long as the change is not timed to achieve a special tax advantage. The vast majority of such taxpayers have been prepaying their taxes as a result of their tax-accounting deviations and the mere fact that *current* revenue is affected by the change should not be significant. The situation is a bit different where taxpayers have adopted one of several optional methods of accounting and desire to change to another. Examples of such changes include a service business without inventories desiring to change from the accrual to the cash method; a farmer with inventories desiring to change from the accrual to the cash method; or a contractor using the percentage of completion method desiring to change to the completed contract method with respect to contracts in progress. Although there are some cases of this kind where the original method was adopted by small business without adequate advice, it is not unreasonable for the Commissioner to presume that there were adequate reasons and advantages, and for him to require not only a convincing business reason but also to take into account the effect on the revenues.

A practical solution to changes from one correct method to another correct method is the deferral and amortization of the revenue effect over a reasonable period of years. This solution appears to be evolving on a case-by-case basis with the ten years used in section 481 (b) (4) (B) for spreading positive 1939 Code years' adjustment as a bench-mark. Authority for these negotiated arrangements apparently exists in section 481 (c). Negotiations to date indicate an ultraconservative approach on the part of IRS personnel both to the amortization period and to the absolute, rather than relative, size of deductions or of income deferral which will be permitted under any circumstances. It is to be hoped that this attitude will be tempered by continued evidence of good faith on the part of taxpayers and tax practitioners, and by the realiza-

tion by IRS personnel that a dike does not crumble when someone removes his finger from a pin-hole.

NOTES

1. §II (A) (1).
2. H. Rep. No. 922, 64th Cong., 1st Sess., 4 (1916).
3. §8 (g); similarly §13 (d) for corporations.
4. *U. S. v. American Can Co.*, 280 U. S. 412, 74 LEd 518, 50 SupCt 177 (1930).
5. *John G. Barbas*, 1 B.T.A. 589 (1925).
6. §212 (b).
7. *Ibid.*
8. TreasReg 118, §39.41–3.
9. I.R.C. of 1939, §41.
10. TreasReg 118, §39.41–2 (a).
11. *Ibid.*
12. TreasReg 118, §39.41–2 (c).
13. *Ibid.*
14. *Brown v. Helvering*, 291 U. S. 193, 78 LEd 725, 54 SupCt 356 (1934); *Schram v. Comm.*, 118 F2d 541 (6th Cir 1941).
15. *Simon v. Comm.*, 176 F2d 230 (2d Cir 1949); *Jerome K. George*, 27 B.T.A. 765.
16. *Schram, supra*, n. 14; *Pacific Vegetable Oil Corp.*, 26 T.C. 1 (1956).
17. *Hygienic Products Co. v. Comm.*, 111 F2d 330 (6th Cir 1940), cert. den. 311 U. S. 665, 85 LEd 426, 61 SupCt 22 (1940).
18. *Advertisers Exchange, Inc. v. Comm.*, 240 F2d 958 (7th Cir 1958).
19. *Pacific Grape Products Co. v. Comm.*, 219 F2d 862 (9th Cir 1955); *Geometric Stamping Co.*, 26 T.C. 301 (1956).
20. *Caldwell v. Comm.*, 202 F2d 112 (2d Cir 1953); *William Hardy, Inc. v. Comm.*, 82 F2d 249 (2d Cir 1936).
21. *Hardy, supra.*
22. *Comm. v. Dwyer*, 203 F2d 522 (2d Cir 1953); *Comm. v. Frame*, 195 F2d 166 (3rd Cir 1952); *Comm. v. Mnookin's Estate*, 184 F2d 89 (8th Cir 1950).
23. Cf. *Brookshire v. Comm.*, 273 F2d 638 (4th Cir 1960); *Advance Truck Co. v. Comm.*, 262 F2d 388 (9th Cir 1958); and *Goodrich v. Comm.*, 243 F2d 686 (8th Cir 1959).
24. I.R.C. of 1954, §§446, 452, 462, 481.
25. S. Rep. No. 1622, 83rd Cong., 2d Sess., 62 (1954).
26. I.R.C. of 1954, §446 (c) (4).
27. I.R.C. of 1954, §446 (d); *Birch Ranch & Oil Co. v. Comm.*, 152 F2d 874 (9th Cir 1946).
28. I.R.C. of 1954, §446 (e).
29. *Supra.*, n. 25, p. 300.
30. I.R.C. of 1954, §481; *supra.*, n. 25, pp. 65 and 308.

31. PL No. 74, 84th Cong., 1st Sess. (1955).
32. §29, PL No. 866, 85th Cong., 2d Sess. (1958).
33. TreasReg §1.481-1 (a) (1).
34. TreasReg §1.481-1 (c).
35. I.R.C. of 1954, §481 (b) (4) (A); TreasReg §1.481-1 (a) (2), 1.481-3.
36. I.R.C. of 1954, §481 (b) (4) (B); TreasReg §1.481-4.
37. I.R.C. of 1954, §481 (b) (4) (C); TreasReg §1.481-4 (c).
38. I.R.C. of 1954, §481 (b) (4) (D).
39. TreasReg. §1.481-1 (c) (2) (ii).
40. I.R.C. of 1954, §481 (b) (1) and (2); TreasReg §1.481-2.
41. I.R.C. of 1954, §481 (b) (6); TreasReg §1.481-4 (d).
42. I.R.C. of 1954, §481 (c); TreasReg §1.481-5.
43. TreasReg §1.481-1 (c) (1).
44. I.R.C. of 1954, §446 (c).
45. *Supra.*, n. 25, p. 300.
46. TreasReg §1.446-1 (e) (2) (i) and 1.481-1 (a) (1).
47. TreasReg §1.446-1 (a) (1).
48. TreasReg §1.446-1 (e) (2) (ii).
49. RevRul 59-285, 1959-2 CumBull 458.
50. RevRul 57-13, 1957-1 CumBull 552; RevRul 58-24, 1958-1 CumBull 318.
51. I.R.C. of 1939, §3801; I.R.C. of 1954, §§1311-1315.
52. I.R.C. of 1954, §446.
53. TreasReg §1.446-1 (c) (1) (iv).
54. TreasReg §1.446-1 (c) (2) (ii).
55. 19T.C.M. 154 (1960).
56. 292 F2d 225 (3rd Cir 1961), 7 A.F.T.R. 2d 1633; cert. den. 11/6/61.
57. 21 T.C. 610 (1954).
58. 218 F2d 607 (10th Cir 1955).
58a. 36 T.C. No. 65 (1961).
58b. 37 T.C. No. 26 (1961).
59. T.I.R. 317 (1961).
60. *Supra.*, n. 25, p. 300.
61. TreasReg §1.471-2 (f).
62. *Harmon*, 34 T.C. 316 (1960).
63. *Geometric Stamping, supra.*, n. 19.
64. TreasReg §1.472-8 (f) (1) and (g) (1).
65. Proposed TreasReg 1.381 (c) (5)-1 (b) (1), Example 2.
66. Proposed TreasReg 1.381 (c) (5)-1 (b) (4).
67. *A.P.C.O. Valve Company*, T.C. Docket No. 86948.
68. *Fruehauf Trailer Company*, T.C. Docket Nos. 88221 and 89949.
69. *Supra*, n. 49.

70. *Dwyer, supra*, n. 22; *Eureka Fire Brick Works*, 5 T.C.M. 1106 (1946) and cases there cited.

71. TreasReg §1.481–2 (d), Example 1.

72. S. Rep. No. 1983, 85th Cong., 2d Sess., 1958–3 CumBull 966.

73. TreasReg §1.481–1 (c) (5).

74. *M. A. Lindner*, D.C., Utah, March 27, 1961; the Solicitor General has authorized appeal.

75. *Brookshire, supra*, n. 23.

76. Regulation S-X, Rule 2.02 (c).

77. *Patchen v. Comm.*, 258 F2d 544 (5th Cir 1958) reversing 27 T.C. 592 (1956).

78. *St. Luke's Hospital, Inc.*, 35 T.C. 236 (1960); appeals of both parties to 4th Circuit dismissed pursuant to stipulation 8/14/61.

79. Citing *Geometric Stamping, supra*, n. 19; *National Airlines, Inc.*, 9 T.C. 159 (1947); *R. G. Bent Co.*, 26 B.T.A. 1369 (1932).

80. TreasReg §1.472–2 (h).

81. I.R.C. of 1954, §472 (c).

82. §820; predecessor of present §§1311–1315.

83. *Graves*, What Constitutes a Change in Accounting Practice, in Proceedings of New York University Sixteenth Annual Institute on Federal Taxation, 1958, p. 555; *Mullock*, The Overlap of Section 481 and Sections 1311 to 1315, 39 Taxes 222.

84. I.R.C. of 1954, §§1311 (a), 1313 (a).

85. I.R.C. of 1954, §1314.

86. *D. A. MacDonald*, 17 T.C. 934 (1951); *Gooch Milling & Elevator Co.*, 75 FSupp 474 (CtCl 1948).

87. *Gooch Milling & Elevator Co.*, 78 FSupp 94, 111 CtCl 576 (1948); *Cory v. Comm.*, 261 F2d 702 (2d Cir 1958), cert. den. 77 SupCt 43 (1959); RevRul 58–327, 1958–1 CumBull 316.

88. I.R.C. of 1954, §1311 (b) (1).

89. *Albert W. Priest Trust*, 6 T.C. 221 (1946); for an apparently different view, see *Heer-Andres Investment Company*, 22 T.C. 385 (1954).

90. 17 T.C. 786 (1951).

91. *Heer-Andres, supra*, n. 89, p. 390.

92. *Estate of A. W. SoRelle*, 31 T.C. 272 (1958).

93. Reported as *Elsie SoRelle*, 22 T.C. 459 (1954).

94. I.R.C. of 1954, §167 (e).

95. TreasReg §1.472–3; the propriety of the election is determined in connection with the examination of the tax return.

96. TreasReg §1.453–7 (a).

97. TreasReg §1.1502–44; RevRul 55–732, 1955–2 CumBull 379.

98. TreasReg §§1.168–3, 1.169–5.

99. TreasReg §1.446–1 (e) (3).

100. T.I.R. 318 (1961); TreasReg §1.446–1 (e) (3) as amended by T.D 6584.

101. 1958–2 CumBull 174.

Employee Benefits—An Important Business Function

By Robert D. Collins

There are many facets to the employee benefit field, both from the standpoint of the types of benefits available and the many interested parties. The most common forms of employee benefits are:

Pension Plans
Profit Sharing Plans
Thrift Funds

Group Insurance or Welfare Benefits, such as:

Life Insurance
Disability Insurance and
Medical Benefits

And, for the key employees there are also:

Stock Options, and
Deferred Compensation Contracts.

It is obvious that any of these programs can have many ramifications on the operations of a business.

Employees are directly interested in the degree to which they participate in a benefit program. The Supreme Court has ruled that a plan is part of the "terms and conditions of employment." Many companies have found benefits a valuable tool in attracting and retaining qualified employees. The unions, as representatives of the employees, have shown a great deal of interest in the benefit field and in many cases, national unions have attempted to apply uniform patterns of benefits to all employers without regard to the specific industry or area problems that might be involved.

The financial operations of a company are directly affected by the costs of benefit programs. This involves not only the financial officers of the company but also the Internal Revenue Service in determining whether a cost is a deductible business expense; the investors in a business in determining the effect of these benefits on the current and future earnings of the business; and the auditors in ascertaining that the method of reporting cost is in accord with generally accepted accounting principles.

Costs of Benefits

Employee benefits are not cheap. Statistics are not always comparable, but a recent survey by the U. S. Chamber of Commerce shows costs for pensions, group insurance and profit-sharing running 5% to 15% of payroll. Those companies where payroll costs are a substantial portion of the sales dollar can find their competitive sales prices seriously affected unless their benefit programs are helping to get better quantity and quality of effort from their employees.

In slack periods benefit costs do not usually decrease in the same ratio as payroll decreases. Short work weeks have little effect on pension and group insurance costs. Layoffs are usually on a seniority basis which means the older, longer service employees remain. These are the ones who are most costly for pensions, life insurace and medical expense (except maternity benefits).

There is no limit to the variations in programs that are available. The employee benefit field has its Rolls Royces and its Volkswagens. Both will get you to your destination although there may be considerable difference in the style, speed, comfort and cost involved.

Planning to Control Costs

There are many things which result in hidden costs in an employee benefit program. Perhaps a few illustrations will be help-

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ful. They were selected to indicate the type of situations, not to indicate errors in planning. Perhaps the companies involved are happy to spend their money in this manner.

1. A company which had a published pension plan had never funded any of the costs and was paying out of current income the pensions as they fell due. It sold one of its divisions for $5,000,000. The selling company agreed to continue to pay those who had retired and the President of the buying company announced to his new employees, "None of your former benefits will be decreased." He did not realize that by this statement he acquired a $4,000,000 liability for unfunded accrued pension benefits.

2. A large company had a pension plan under which the benefit accruals for each year of service would be related to the individual's pay in the five years before retirement. About 25 years ago, when Social Security became operative, the company changed its plan and froze the amount of prior service accruals to be applied at retirement under the "final pay" plan. At that time there were sufficient funds to meet the actuarially determined costs assuming moderate salary increases in the future. Because of the upward spiral of earnings in the intervening years, the company has paid into the fund additional millions and may have more to go before the last of the pensions based on the old formula is paid.

3. A company was receiving substantial cash dividends because of low claims under its group life insurance plan. It was told that these dividends would support continuing the full amounts of group life insurance for retired employees. Some years have passed and the employee group is older. The average cost per thousand of insurance on active employees is higher than it was and the actual group life insurance payments on deceased retired employees will soon be at a rate in excess of $1,000,000 per year.

4. A company installed a modest pension plan which was the maximum it felt it could afford. Because the pensions being produced were quite small the company supplemented the pension with out-of-pocket pay continuance for most pensioners. The company did not realize that agreement to continue $100 per month to a man age 65 will produce, on the average, $17,000 of total payments. The lump sum actuarial value at age 65 is about $14,000. Others have made the even more expensive decision to keep superannuated personnel on the payroll at full salary for 50% performance.

5. A company found it desirable to amend its pension plan to improve the benefits and change the method of funding. It failed to make one basic amendment to its prior plan and all persons under the old plan received fully vested rights to the accrued benefits even though formerly 15 years of service was required before vesting was effective. Each person who quit the company with less than 15 years of service took with him a piece of pension to which he would not have been entitled if the method of funding had not been changed.

Many more examples could be given of hidden costs that have been built into employee benefit plans. Examples could also be cited where the plan failed to meet the needs of the employees and, therefore, failed to stimulate employee effort. No consult-

ant can tell a client how it must spend its funds. He does have a responsibility to see that the employer is aware of the probable result of any action. Remember, when you buy that cute kitten you are buying a cat. If you want a cat this is just fine but you must recognize the ultimate result when the purchase is made. Employee benefits, too, will be around for a long time. If you change your mind you can't just give it to someone or phone the American Society for the Prevention of Cruelty to Animals.

Developing a Plan

There are many well designed plans which are the result of intelligent planning on the part of the company with the help of qualified advisors.

The executives of a company who are responsible for finances and for personnel are the ones whose functions are most directly affected in the design of a broad employee benefits plan. But, the operating executives in other departments will generally be the ones who have the larger number of employees reporting to them and who will thus be confronted with the effect of the plan on the people and through them on the operations of the business. Designing a proper plan usually involves enlisting the thinking of all the top executives on the problem and its solution.

In a few words, the job is to determine the ultimate program which would be of the most benefit to the company and in turn to its employees if costs were not a consideration. This requires an analysis of the needs of the employees, the part the company should play in meeting these needs, the results required by the company to make it economically feasible to provide a broad benefit program and the benefits that will help accomplish these results.

There is then considered the current status of employee benefits in the company and such things as union philosophy with which the company is confronted and the degree to which government sponsored programs are available or contemplated. The costs of various alternate benefit programs can then be developed. This will be the basis for determining to what extent benefits should be currently provided and the possible improvements that can be made over the years. There is no one best plan and no plan should remain indefinitely without review and perhaps modification.

Getting Employee Acceptance

Even if an excellent plan is designed and installed, unless it is understood by the employees and carefully administered by the company, it will fail to attain its objectives. Continuous effort year in and year out is required to see that the benefits are not forgotten or taken for granted. Available space does not permit detailed discussion of the writing of employee booklets, the counseling of employees, the reporting to employees of the results of the plan, the preparation of employees for retirement, and similar techniques in employee benefit administration.

Conclusion

Employee benefits are here to stay. Every employer requires a sound program designed to fit his needs and objectives. Unless the employer is getting a return for his investment in benefit plans he is throwing money away.

Family Tax Planning and Oil and Gas Properties

By G. W. Welsch

Oil and gas property interests provide valuable tools for the income and estate planner. The various types of property interests which have been devised to meet the necessities of the industry, such as royalties, oil payments, carried working interests and net profit interests, have various tax and economic effects which, in appropriate circumstances, can be used to advantage to build up an estate at the least tax cost.

The two main tax advantages associated with the ownership of oil and gas interests are the deduction for depletion and the right to write off intangible drilling and development costs when the required election has been made.

The deduction for intangible drilling and development costs is available only to the owner of the operating or working interest. No problems arise in situations where the operator acquires the working interest alone, or jointly with others, and each co-owner pays his proportionate share of the drilling and development costs with the intention that the property be developed and retained by such co-owners. However, because the deduction for intangible drilling and development costs has such tax advantages to the high bracket taxpayer, efforts have been made by promoters to devise arrangements whereby high tax bracket investors can be allocated more than their proportionate share of such costs. These arrangements include carried working interests, net profits interests, farmouts with retained nonoperating interests, joint ventures which do not elect not to be taxed under Subchapter K and similar devices. The basic purpose of these various arrangements is usually to allocate the tax-deductible items to the taxpayers who can use them to the greatest advantage. In planning for family ownership of oil and gas properties, care should similarly be taken to allow the high tax bracket members of the family all of the deductions possible under the law while shifting maximum income to the low tax bracket family members.

Because income taxes are levied at graduated rates, it is often desirable to create as many taxpayers as possible by the transfer of property to children, either outright or in trust. The many different types of property interests which can be created out of a single oil and gas lease, each with different tax consequences, make

oil and gas properties an ideal subject for division among the family when the transaction has been carefully planned.

Unfortunately, final regulations have not yet been promulgated under the intangible drilling and development sections of the Internal Revenue Code, and this fact, plus the fact that intrafamily transactions are closely scrutinized, when they produce tax advantages, gives rise to a gray area wherein certainty with respect to the tax effects of contemplated transactions will be lacking.

Let us consider some specific examples of possible forms of ownership of oil and gas properties by the members of a hypothetical family and the economic and tax results which might flow from proper planning.

Mr. X is a wealthy man in a high income tax bracket. In order to lessen his estate tax he has created trusts for his children and has made substantial gifts to these trusts so that he is now also in a fairly high gift tax bracket. He realizes that additional gifts would result in income and estate tax savings that would exceed the gift tax cost but he would prefer some other means of increasing his children's estates. To reduce his current year's income tax liability, he intends to acquire some unproven properties and "drill up" his top bracket income.

If Mr. X acquires leases in his own name and drills them up, he will have accomplished his purpose of reducing his current

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year's taxable income by the amount of the intangible drilling and development costs incurred.

But what happens if he finds oil? He has added another valuable asset to his estate and increased his income tax problems for future years. A gift of this proven property to his children's trusts would incur substantial gift tax liability.

If, prior to engaging in any development work, Mr. X assigned nonoperating interests in these properties to his children's trusts, the gift tax, if any, should be nominal because the unproven properties would not have any substantial value. The nature of the interests to be transferred would depend on the over-all estate picture, but regardless of whether the trusts received overriding royalties, net profits interests or carried working interests, Mr. X would still be entitled to his deduction for intangible drilling and development costs. Thus, the trusts would receive income-producing property at little or no cost. Another possibility might be to have the trusts acquire the property initially and farm it out to Mr. X, retaining overrides, carried working interests or net profit interests. This might eliminate the possibility of gift tax.

Let us assume that Mr. X failed to properly plan his property acquisitions and that, as a result of his drilling program, he developed a valuable oil and gas property. He wishes to turn this property over to his children's trusts without paying gift tax. Can he sell this property to the trusts in an ABC deal?

At this point it might be advisable to review the ABC transaction and see how it works. A, the owner of the working interest in an oil and gas lease, desires to sell all of his interest in the lease for $500,000. C, an operator, wishes to buy the property but he only has $100,000 available. He can borrow $400,000 at a bank, mortgaging the property as security and applying 80% of the gross runs to pay off the mortgage but if he does he will find himself in a minus cash position each year. The retained 20% of the runs will be sufficient to operate the property but even though the proceeds of 80% of the runs are going to liquidate his indebtedness at the bank, and thus are not received by him, they are included in his gross income for tax purposes.

His tax advisor suggests that instead of borrowing the money, he pay $100,000 to A for the working interest subject to a retained $400,000 oil payment payable out of 80% of the oil and gas to be produced and that A sell the oil payment to a third party, B, for $400,000. The oil payment would bear interest at 6% on its declining balance. If B borrowed the $400,000 from the bank at

$5\frac{3}{4}\%$ his profit would be limited to the difference between the interest received and the interest paid, in this case $\frac{1}{4}\%$, but he would have no capital invested in the deal. C, never having owned the oil necessary to liquidate the retained oil payment, would not be required to include in his gross income any portion of the proceeds from the sale of oil necessary to liquidate it.

The ABC transaction can take many forms. A can sell his entire property to B and then B can sell the working interest to C. Sometimes it is necessary to make it into an ABCD transaction in which A sells his entire property to D who sells the working interest to C retaining the oil payment. Then D sells the retained oil payment to B. Whatever the form of the transaction, the tax consequences to each individual are supported by a long line of cases.

Until the middle of 1961, there was no problem in getting a ruling from the Treasury to the effect that A, having disposed of his entire interest in the property, would realize capital gain on the sale of both the oil payment and the working interest, that B would be taxed on the difference between the amount paid for the oil payment and the amount received, at ordinary income tax rates, and that C would never have to include in income the amount used to liquidate the oil payment.

On July 17, 1961, the Internal Revenue Service announced in TIR-326 that it was considering a change in its position with respect to the income tax treatment of the ABC transaction and stated that it would welcome comments and suggestions from interested parties. In response to this request petroleum companies, trade associations, accountants and attorneys submitted briefs in support of the retention of the historical tax treatment of ABC transactions. On September 15, 1961, the Internal Revenue Service issued TIR-338 which reads as follows:

> "U. S. Commissioner of Internal Revenue Mortimer M. Caplin announced today, concerning TIR-326, that IRS will now resume ruling in appropriate cases as to the income tax treatment of mineral production payments under arrangements commonly referred to as "ABC" transactions.
>
> "Commissioner Caplin stated that requests for rulings on arm's length "ABC" transactions between unrelated parties will be considered on the merits and rulings issued where appropriate.
>
> "He further stated, however, that the IRS is completing its study of the ramifications of "ABC" transactions and plans to publish precise rules relating to the tax treatment of this type transaction."

It would seem that the reference in this announcement to "arm's length transactions between unrelated parties" would elim-

inate any possibility of procuring a ruling on intra-family transactions. Just how far the Service intends to carry this point will not be known until the results of the further study are made public. However, it would appear that Mr. X will be subject to considerable tax risk if he enters into an "ABC" deal with his children's trusts.

Let us assume that Mr. X decides that he wants to make further gifts to his children and to the trusts which he has established for their benefit. He asks you to review his holdings and tell him what would be the best subject matter for the gift. You find that he owns both producing and nonproducing properties, including royalties and working interests, and that he also has a portfolio of stocks and bonds. Some of these securities have appreciated substantially in value since they were acquired.

There are certain general principles which apply to the selection of property for gifts. Let us first review these principles and then see how they apply to oil and gas properties.

Montgomery's Federal Taxes[1] lists the following as some of the general rules:

1. Property should be given which has not substantially appreciated in value if there is any possibility that the donee may ultimately sell the property. Property with substantial appreciation should be retained for testamentary disposition in order to get a stepped-up basis.

2. Property which has depreciated in value so that a tax loss will result should be sold to an unrelated purchaser, the donor deducting the loss on the sale and making a gift of the proceeds of the sale instead of the property.

3. Property with potential appreciation qualities should be given. Wasting, depreciating or deteriorating assets, and licenses, contracts and other assets with terminable values should be retained.

Applying these rules to oil properties, you ascertain that a producing oil property is a wasting asset, usually with an extremely low basis and with little or no hope of appreciation in value. The probabilities are that it will be worth less at the time of the donor's death than at the date of the gift. Moreover, the depletion deduction available for income tax purposes against the income from producing properties will probably be of more value to high tax bracket Mr. X than to the lower tax bracket children and their trusts.

So at first glance, it would appear that you can rule out the producing properties, both working interests and royalties, as proper subject matter for gifts.

The term "wasting assets" as used in the rules set forth above means assets which will be wholly or partially consumed between

the date of the gift and the date of the donor's death and therefore nonproducing properties would not come within this definition. Moreover, nonproducing properties have potential appreciation qualities probably greater than any other type of asset. Usually they either become of substantial value or become completely worthless. Although such properties ordinarily have little tax basis, this becomes of minor importance where it is intended that the recipient of the gift retain the properties after they have been developed. The tax basis has no significance because percentage depletion is allowable regardless of basis. It would therefore appear that the nonproducing properties should be given further consideration as the subject matter of the intended gifts.

Because this paper is restricted to the use of oil and gas properties in family planning, let us assume that you have reviewed all of the other assets owned by the client and determined that they were unsuitable as the subject matter for gifts. You now return to the nonproducing properties and determine that they fall into three classes:

1. Oil and gas leases.
2. Mineral interests upon which leases have not been granted.
3. Royalties retained upon the granting of oil and gas leases.

Upon discussing the situation with the client you ascertain that he is holding the undeveloped oil and gas leases for future development. You point out to him that to dispose of these properties would seriously interfere with his income tax planning because such planning calls for the orderly drilling up of high tax bracket income. You suggest that possibly he might wish to make gifts of overriding royalties and net profits interests in these leases.

With respect to the unleased minerals you determine that negotiations are presently under way which may lead to the leasing of some of these tracts to a large oil company. An immediate gift of these properties would appear to be in order because:

(a) The granting of a lease with a development clause would probably enhance the value of the property, increasing gift tax cost, and

(b) Any lease bonus to be received would be taxed as ordinary income subject to depletion and substantially less tax would be incurred if such bonuses were received by lower bracket taxpayers.

The royalty interests which have been retained where oil and gas leases were granted would also make excellent subject matter for gifts. The delay rentals on such leases would be taxed to lower bracket taxpayers; if any of the leases should prove productive, the royalties would go to build up the children's estates; and in

the event that any of the leases should be abandoned without production, Mr. X would not be required to restore to income the depletion previously taken on the bonuses received.[2]

Obviously, the foregoing is an oversimplified presentation of the problem and its solution but it does serve to point up some of the considerations which must be kept in mind in selecting property for gifts.

In making gifts advantage should be taken of the $3,000 annual gift tax exclusion for each donee. Where the property to be transferred exceeds the available exclusions and circumstances warrant, perhaps the best results can be reached by selling rather than giving the property. For example, assume that Mr. X has just acquired a partially developed oil and gas lease for $120,000. Based on his previous discussions with you, he decides that it might be a good idea if he gives a 25% net profit interest in the lease to each of his two sons. You point out the gift tax involved in these two $30,000 gifts and suggest, as an alternative, that the property be sold to the children with each son signing five notes for $6,000 each, payable annually over the next five years. Then each year Mr. and Mrs. X could give each son $6,000 tax free and the son could use these funds to pay off the note. Of course, the age of the taxpayers, the length of time of the pay-out and the over-all estate plan of the family must be considered in situations such as this.

Mention has been made throughout this paper of various types of interests in oil and gas properties, and it might be well to define a few of the terms and explain the economic and tax effects.

A mineral interest is the total of all rights to oil and gas in place. The owner of the mineral interest may or may not own the surface of the land. If he does not own the surface of the land he nevertheless, as the owner of the minerals, has the right to make such reasonable use of the surface as is necessary to develop the property for production of oil and gas.

If the owner of the minerals grants an oil and gas lease, retaining a specified fraction, in kind or in value, of the total production from the property, free of operating and developing expense, two new property interests come into being. The retained fraction of production is called a "royalty interest"; the interest assigned to the lessee, which is burdened with the costs of developing and operating the property is called the "working interest." If the lessee pays a cash consideration to the lessor as consideration for the granting of the lease, this sum is known as the "lease bonus."

It is treated as an "advance royalty payment," i.e., as ordinary income subject to the allowance for depletion.

If the lease holder "farms out" the tract to another operator, retaining a specified fraction of the production from the lease free of operating and development costs, this retained fraction is called an "overriding royalty." If the retained fraction is limited in duration to a specified number of dollars or a specified number of barrels of oil, instead of being for the life of the property, it is called a retained oil payment. If cash consideration is paid by the assignee of the lease, the tax treatment to the assignor depends on whether the interest retained is an oil payment or an overriding royalty. If the retained interest is an overriding royalty the transaction is treated as a sublease, and the payment is considered to be a lease bonus. If the retained interest is an oil payment, the transaction is treated as a sale. If the assignor held the property over six months and was not a dealer in leases, he is generally entitled to treat any gain realized in such sale as long-term capital gain under either section 1221 or 1231.[3]

These are simple definitions. There are variations to every type of property interest in oil and gas. For example, there are participating and nonparticipating mineral and royalty interests, term royalties, etc. The complicated interests arise when the operator starts to raise funds to develop the property.

Let us consider first the "carried working interest," which can take one of three general forms, each with the same economic results but substantially different tax results. These three forms have been named after three leading cases in which the tax effects of the arrangement were determined by the courts. The most common type of carried interest is the so-called Manahan[4] type, wherein the owner of the working interest assigns the entire property to the investor, who is to pay for the drilling and development of one or more wells. The assignment is subject to a reversionary right which requires the investor to reassign a specified fraction of the working interest (usually 50%) to the original owner after the investor has recovered his development and operating costs from production. If the investor does not recover his costs from production, the reversion will not occur. Since the entire working interest is owned by the investor during the pay-out period, he is subject to tax on total gross income from the property and is entitled to deduct all depletion, intangibles, and depreciation on the capitalized equipment costs. After pay-out and the reversion to the original owner of the specified fraction of the working

interest, the parties operate the property as co-owners, each paying his specified portion of all subsequent costs and receiving his specified portion of the gross income. The owner acquires by reversion an interest in the existing equipment but has no basis for depreciation; the investor loses an interest in the equipment to the owner and has to transfer part of the basis of the equipment to the basis of the property for depletion.

Another type of carried interest is the Herndon[5] type, wherein the owner of the working interest assigns to the investor a fraction thereof plus an oil payment, payable out of production accruing to the retained interest, for the owner's share of development costs and operating costs during the pay-out period. The investor is taxed on the total gross income from the property but, unlike the Manahan type, he owns only a portion of the working interest and therefore may deduct only that portion of the intangibles and capitalize only that portion of the equipment costs. The remainder of the costs of intangibles and equipment constitute the basis of the oil payment. Since the basis of the oil payment for depletion is equivalent to the amount thereof, the investor does not realize any net income from the proceeds attributable to the payment. The owner has retained a fraction of the working interest but, since all costs were paid by the investor, he is not entitled to deduct intangibles or to capitalize any basis in the equipment.

The third type of carried interest is the Abercrombie[6] type, wherein the owner assigns to an investor a fraction of the working interest and grants a lien or mortgage on his retained interest for that portion of the development and operating costs applicable to such retained interest during the pay-out period. The investor in effect, lends the owner the amount of such costs and looks only to production for recovery. Therefore, while the investor receives all the income from production during the pay-out period, he receives a part thereof in payment of the loan and is therefore taxable only on the portion of the income applicable to his share of the working interest. The portion of the costs applicable to the owner's share is treated as a receivable by the investor, and the investor may deduct only his share of the intangibles and capitalize only his share of the equipment costs. While the owner does not receive any proceeds prior to pay-out, a portion of the proceeds is applied in satisfaction of his indebtedness to the investor, and he realizes taxable income to that extent and is entitled to deduct the portion of the intangibles and capitalize the portion of the equipment costs which is paid on his behalf.

The owner of the working interest may not wish to be carried or to pay or be liable for any portion of the current or future costs of developing and operating the property, but may be willing to have his interest bear the expenses applicable thereto. He may grant the entire working interest to an investor and reserve a portion of the net profits from the property. While the courts originally had some difficulty in determining the nature of this type of interest, it is well settled that a "net profits interest" is a nonoperating economic interest extending for the life of the property, which is similar to a royalty except that the owner thereof is entitled to a portion of the net rather than the gross income from the property.[7] Since the investor owns the entire operating working interest, he may deduct all the intangible costs and capitalize all the equipment costs. The owner is taxable on his share of any net profits as ordinary income subject to depletion, and the investor should exclude these amounts from his gross income from the property.

Another mineral property interest in frequent use is the production payment, i.e., the oil or gas payment. This interest is similar to an overriding royalty except that it does not extend over the life of the property but is limited as to term, production or value.

The production payment may be retained in the assignment of a larger interest in oil and gas or it may be carved out of such interest. The tax consequences of the two methods of creating production payments are quite different.

As indicated earlier in this paper, the assignment of an interest in oil and gas properties subject to the reservation of an oil payment therein is considered as a sale or exchange for Federal tax purposes. The grantor should allocate the basis of the property between the assigned and retained interests on the basis of their respective fair market values, and may realize gain from a capital transaction. A subsequent sale of the oil payment would also result in capital gain. In the event a royalty is reserved in addition to the oil payment, it is considered that the grantor has retained a variable interest for the life of the property. The transaction is a lease, and the payment is bonus subject to depletion.

The sale of an oil payment carved out of a larger interest (including a larger oil payment) is more complex. If the payment is so large that it can not reasonably pay out, it may be considered as a royalty. If the payment is expected not to extend over the life of the property, the Internal Revenue Service will take the

position that the grantor has assigned future income from the property and therefore realizes ordinary income subject to depletion.[8] When such an interest is the subject of a donation, the Service considers that any production or payments to the donee constitute ordinary income to the donor subject to depletion.[9]

Sometimes the Service will consider an interest to be an oil payment when none exists. For example, if an individual donates royalty interests to a trust, the income therefrom to be used for the support of his father and the interest to revert to the donor upon the death of the father, the Service has taken the position in private rulings that the donation is of a limited royalty similar to an oil payment and will tax the proceeds received from the interest by the trust as depletable income to the donor.[10] Another example may arise in a sale when a grantor and grantee differ as to the reserves and potential value of a mineral property. The grantor may agree on the price subject to the proviso that, after the grantee has recovered a specified amount of production (barrels of oil or thousand cubic feet of gas), the grantor will be entitled to a limited share of the remaining production. The Internal Revenue Service has indicated that it will consider the transaction as the sale of a mineral property and the front end carved out of a reserved oil payment, and that any part of the price applicable to the carved out oil payment is ordinary depletable income to the grantor.[11]

Of course, if the grantor assigns his entire interest or a fraction thereof, it is considered that he has made a sale or exchange for tax purposes. For example, if the owner of an oil payment assigns a fraction thereof to run concurrently with the interest retained, the transaction is considered as a sale or exchange for Federal tax purposes (i.e., the sale of an oil payment of $25,000, payable out of 1/4 of 7/8 of the first oil and gas produced and saved from the property, when the original interest was a payment of $50,000, payable out of 2/4 of 7/8 of the first oil and gas produced and saved from the property).

The grantor can often vary the transaction to obtain the desired tax results. For example, while the realization of capital gain is usually more desirable than ordinary income, a taxpayer who has a net operating loss, which he can not utilize fully against income of other years (or does not wish to so use it), may assign a carved out oil payment in order to realize ordinary income against which to apply the loss.

There are instances in which the assignment of an oil payment does not constitute a sale or exchange and is not an anticipation of future income for Federal tax purposes, but is an investment by the assignee in the development of the mineral property. This situation arises when the funds received for the oil payment (or other nonoperating interest) are pledged to be used in the development of the property out of which it is carved, or the oil payment is assigned in exchange for the drilling or equipping of the well (up to and including the Christmas tree), the furnishing of materials, or the rendition of services prior to the completion of development (such as the services of the lease broker, geologist, driller, title abstractor, attorney and accountant). Neither the assignor nor the assignee realizes gain or loss from the assignment for Federal tax purposes,[12] and this treatment facilitates the financing of the development of the property. The party who supplies the materials or equipment or renders the services capitalizes as the basis of his investment for depletion the cost of the materials, equipment and services; neither party may deduct the cost of intangibles or capitalize the cost of equipment for depreciation purposes.

The above principles do not apply to the operation of the property after the property has been fully developed. Also, the assignment must not be in satisfaction of a pre-existing obligation, and the assignee must recover his investment solely from the production from the property with no personal liability therefor on the part of the assignor.

The assignee of a production payment in all the aforementioned situations realizes ordinary depletable income on, and the assignor excludes from gross income, any proceeds or production attributable to the payment.

Oil and gas investments in states other than that in which the taxpayer is domiciled can cause certain complications, which may be costly and which should be considered in income and estate planning. Such interests are investments in real property and will be governed by the property laws of the particular state. Aside from the fact that the taxpayer may be required to file income tax returns in those states, his attorneys must institute ancillary estate proceedings in those states, inheritance taxes must be paid to the state authorities, and title to the properties must descend to the heirs in accordance with the laws of the particular state. Some states have laws of forced heirship and do not recognize the validity of, or impose certain restrictions on various property

rights and conveyances which are very useful in estate planning, such as inter vivos gifts, trusts, powers of appointment and future interests. Some states have adopted civil codes and have superimposed on those codes certain basic statutes in particular areas (corporations, trusts, etc.) similar to the statutes in common law states. Some have adopted community property laws, and others have followed the common law concept of property ownership. In short, there is considerable lack of uniformity among the various states, and it is often necessary to retain legal counsel from the particular state to advise on matters affecting the taxpayer in that state.

Investments in oil and gas properties in foreign countries present similar problems. There may be some advantages, however, in that such properties would not be includible in the gross estate for U. S. taxes and may be subjected to lower foreign estate taxes.

NOTES

1. *Montgomery's Federal Taxes*, 38th Edition (The Ronald Press Company, New York, 1961), page 22.15.

2. Rev. Rul. 60–336, 1960–2 C.B. 195.

3. See I.T. 3693, 1944 C.B. 272, and Rev. Rul. 55–526, 1955–2 C.B. 574; cf. Rev. Rul. 61–55, 1961–13 I.R.B. 16.

4. *Manahan Oil Company*, 8 T.C. 1159 (1947).

5. *Herndon Drilling Co.*, 6 T.C. 628 (1946).

6. *J. S. Abercrombie*, 7 T.C. 120 (1946), aff'd. 162 F. (2d) 338 (CA5–1947).

7. *Burton Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946).

8. *Commissioner v. P. G. Lake, Inc. et al.*, 356 U.S. 260 (1958).

9. I. T. 3935, 1949–1 C.B. 39.

10. See "Oil Payment Developments—Post P. G. Lake," Oil and Gas Quarterly, Vol. IX, No. 3, pp. 145, 146; Income Taxation of Oil and Gas Production, Breeding & Burton, p. 604.

11. "Oil Payment Developments—Post P. G. Lake," *supra* note 10, pp. 139, 140, 141.

12. G. C. M. 22730, 1941-1 C.B. 214.

Subchapter C Problems

By Frances B. Rapp

Since the passage of the 1954 Internal Revenue Code and the promulgation of the Regulations on Subchapter C, there have been few court decisions dealing with the intricacies of Subchapter C provisions, particularly in the incorporation and reorganization areas. The issuance of many private rulings on specific cases and the Internal Revenue Service's policy of publishing rulings of general interest have served to benefit taxpayers greatly. However, the paucity of court decisions on the new provisions has, perhaps, caused too great reliance upon obtaining advance rulings.

New No-Ruling Area Announcements

Of the occurrences in this area within the past year or two, by far the most significant and the ones which have caused the most confusion, have been the Service's announcements in Technical Information Releases that the no-ruling area had been broadened to cover several important problems arising under Subchapter C.

It seems that, as a general rule, taxpayers "view with alarm" any discouraging words from tax officials—by pen or mouth. The taxpayer wonders whether there is some esoteric meaning behind ordinary words and terms of the law, whether there may be developing a theory, as yet undisclosed, or whether someone has just decided that Congress should have said something which it did not, or vice versa.

In writing the law, Congress has provided only paper-thin distinctions between the taxable and the nontaxable transaction and where the draftsmen left off, the Commissioner must begin. Under such circumstances, the reluctance of taxpayers to act without an advance ruling is understandable. In analyzing the possible impact of the broadening of the field where advance rulings will not be issued, the following observations may be worthy of note.

In general, it may be reasonable to construe an announcement which does not go beyond saying that no advance rulings will be issued under certain circumstances, as merely a reflection of a reluctance on the part of the Commissioner of Internal Revenue to give a taxpayer a "blessing" where transactions contemplated are such that may ultimately result in less revenue than the Commissioner believes Congress actually intended, regardless of the

literal language of the law. Whether the Commissioner may believe that a consummated transaction similar to those described in an announcement could be successfully challenged is something else again. On the other hand, a taxpayer's apprehension arising from the announcement of a no-ruling policy may be well justified. This was positively demonstrated by the recent Revenue Ruling 61–156, which apparently was foreshadowed by Technical Information Release 310, relating to the problem of a liquidation followed by a reincorporation.

More specifically, let us first consider the possible implications of Technical Information Releases 311 and 312, dealing with the applicability of section 351 to the formation of investment companies and real estate investment trusts, respectively, as a result of solicitation by promoters, brokers, or investment houses.

Despite the fact that no advance rulings in these areas may be obtained, it is believed that as to transfers by various parties as steps in an integrated plan, the result of which is the formation of a corporation or an association taxable as a corporation which carries on a business such as ordinarily carried on by an investment company or a real estate investment trust, the courts may be expected to rule the same as they would have had there been no participation of others than the transferors in the formulation of the plan. Therefore, if the literal requirements of section 351 of the Code are satisfied, there is a very good chance of a taxpayer succeeding in having his transfer under these circumstances treated as nontaxable.

The United States Supreme Court in the case of *Cement Investors, Inc. v. Helvering*, 316 U.S. 527, laid down certain principles relative to the tax consequence of the transfers of property

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to controlled corporations. It hardly seems conceivable that at this late date the language in the law will be accorded any hidden meanings.

It seems that if the Commissioner felt that a more frontal assault could be made against the technique now ostensibly frowned upon, the public would have been apprised of that fact by this time. If the various District Directors have been informed of some legal deterrent against the applicability of section 351 by reason of the nature or amount of the property, or the kind of business of the transferee, it appears quite probable that the details of the deterrent contemplated would have "leaked out."

Another thought which we might consider in this connection is that there may be concern on the part of the Service that the publicizing by it of a positive view that the applicability of section 351 depends on such facts as are referred to in these Technical Information Releases could "boomerang." No doubt situations will occur where it would not be in the interest of the revenue for the Service to agree that, since transfers had been made in response to solicitation of brokers or others, the provisions of section 351 were inapplicable. A stepped-up basis of properties might well prove decidedly advantageous taxwise to the corporation involved and to its shareholders in future years.

Continuity of Business Test

In searching for the reasons motivating these announcements, one could perhaps rationalize that the interpretation of section 351 depends upon the judicial test commonly called a "continuity-of-business" test used in a reorganization. That test is just another way of stating, or is an amplification of, the "business purpose" requirement, which grew out of the decision of the United States Supreme Court in *Gregory v. Helvering*, 243 U.S. 465, where a "sham" or "mere device" was disregarded.

The extent to which the judicial tests for a reorganization impinge upon section 351 has not been clearly fixed by the courts. Authority does exist for the proposition that transactions carried out for the "sole purpose of minimizing Federal tax" (an extension of the *Gregory* rule) are outside that section. On the other hand, one can find little authority for applying the "continuity-of-business-enterprise" test as transfers to controlled corporations frequently are the first step in the commencement of a business enterprise. Applying such a test would not be in harmony with the general purpose of the provision.

In taking the view that the "continuity-of-business-enterprise" test is not applicable in this area, one obtains encouragement from the historical background of section 351. In enacting the 1954 Code, consideration was undoubtedly accorded the fact that the tax deferral provisions sometimes afforded a vehicle for tax avoidance. In many provisions of the Code, language was used which purports to bar a reliance on the general rules applicable to ordinary transactions if "tax avoidance" was a principal purpose motivating a specific transaction. The regulations covering section 351 have evolved from over thirty years' experience with an essentially similar provision. They have not in any way indicated a "continuity-of-business" requirement. In House Report No. 1337 with respect to the section, it was stated: "No change is intended by your Committee as respects the basic purpose of this section."

The famous philosophy of the late Judge Learned Hand as expressed in *Chisholm v. Commissioner*, 79 F. (2d) 14, seems pertinent in this connection. In commenting on the *Gregory* case, he said: "Had they really meant to conduct a business by means of the two reorganized corporations, they would escape whatever aim they might have had, whether to avoid taxes or to regenerate the world." That view is authority for the opinion stated previously, that if corporate transferees do actually engage in the business for which they are organized, any transfers which meet the mechanical requirements of the section 351 would escape the immediate recognition of gain or loss. The distaste on the part of the Service for the type of transaction described in Releases 311 and 312 may finally result in changes in the Code. But this may not happen. It may be recalled that for quite a long time it has been public information that some Treasury officials looked with disfavor on the issuance of both stock and securities for assets of a transferor, or transferors, upon the original formation of a "controlled corporation." Nevertheless, Congress has never indicated that it regards that procedure as violating the basic principle of tax deferment; nor have the courts, except in the case of "thin capitalization." Whether that type of transaction may be effectively road-blocked by reason of the fact that no advance rulings may be obtained is conjectural.

Reorganization of Investment Companies

Another situation where it may be assumed that an unfavorable attitude on the part of the Service exists, involves a reorganization in connection with which an investment company acquires

stock and securities from another such company. We might surmise that the "smell test" gave rise to the notice of the no-ruling policy in that area. However, if there is a repugnant odor, it is only a natural concomitant of section 852, prescribing special rules for taxation of regulated investment companies and their shareholders, and section 368(a)(1), defining a reorganization. Again, in the absence of more enlightenment as to whether, in announcing in Technical Information Release 309 that no advance rulings would be issued in this area, the Commissioner envisioned a possibility of having the issue litigated, one can only speculate and must attempt to appraise the outcome if such reorganizations are consummated without a ruling. Much guidance may be obtained from a volume of court cases interpreting the statutory definitions of a "reorganization," such as would be involved in a transfer of assets by one investment company to another. Moreover, the inherent purpose and legal results of the tax-postponement provisions have been exhaustively explored by many able writers on the subject. Consideration of their views leads to the conclusion that no violence is done to the statutory or judicial requirements by treating a "reorganization" between two investment corporations as just what it purports to be. Sometimes, however, our judges do not confine themselves to enforcing old rules. They make up new ones, or alter old ones quite readily, if deemed necessary to preserve the "integrity of the revenue laws." Whether a "reorganization" of investment companies would warrant espousal of any new judicial rules is problematical. Whether "reorganizations" of investment companies would abuse Congressional intent in enacting the law is obscure.

"*Reincorporation*" *Problem*

The public was informed through Technical Information Release 310 that the "no-ruling" area had been extended to cover the situation where shareholders of the "liquidated" corporation would own more than a "nominal" amount of stock in a new corporation which would carry on a corporate business in which the "liquidated" corporation had engaged. Previously, transactions patterned after Rev. Rul. 56–541 were thought to be certain of Service approval. Under that ruling, a "sale" was treated as a "sale" for the purposes of sections 337 and 331, even though it was planned that shareholders of the "selling" corporation would own as much as 45 per cent of the stock of the purchasing corporation. The term, "more than a nominal," used in the Technical

Information Release caused great confusion in an area where greater clarity and definiteness were already highly desirable.

It is understood that the Service now takes the view that "more than a nominal amount" means more than 20 per cent. That apparently would mean that the provisions of sections 337 and 331 will apply if the owner or owners of not more than 20 per cent of the stock of the selling corporation own the stock of the purchasing corporation. Conversely, if the shareholders of the old corporation, as a group, own not in excess of 20 per cent of the stock of the purchasing corporation, the applicability of sections 337 and 331 is not barred.

Prior Law Versus 1954 Code

Where the reincorporation question was raised under the 1939 Code, the courts sought to reach an answer by finding out whether the steps taken constituted a reorganization under definition (D) of section 112(g)(1) of that Code. It does not appear that the issue was ever resolved by reference to definition (E) or (F) of the Code.

The (D) definition of a reorganization became limited in function upon the passage of the 1954 Code, which was drafted with an historical background that must have been well considered but which left much to be desired with respect to certain transactions which had been covered by the (D) definition contained in the 1939 Code.

The regulations under section 331 of the Code warned that some transactions which were liquidations in form might not be so treated for income tax purposes under some circumstances. But the language used afforded little, if any, guidance as to what "continuity of interest" would be required before a transaction, in form a liquidation, would be regarded as other than a "liquidation."

In the case of *Austin Transit, Inc., et al.* (20 T.C. 849, acquiesced 1954-1 C.B. 3), although the Tax Court assumed that the liquidation and subsequent transfers to three corporations in which the old shareholders owned a 69 per cent interest were pursuant to a plan, the decision was reached that a "statutory" reorganization within the meaning of section 112(g)(1)(D) of the 1939 Code did not occur, since the old shareholder owned less than 80 per cent of the transferees. The Tax Court distinguished the cases of the *Estate of John B. Lewis* [176 F.(2d) 646] and *Survaunt* [162 F.(2d) 753] by the fact that the shareholders in those cases owned

100 per cent of the acquiring corporations. In *Civic Center Finance Co. v. Kuhl*, 83 F. Supp. 251 (E. D. Wisc., 1948), aff'd *per curiam*, in 177 F.(2d) 706, the participation by 40 per cent of the former stockholders was held insufficient to provide "continuity of interest." *A fortiori*, it would seem that if continuity of interest on the part of the old shareholders was represented by less than 40 per cent of the stock of a transferee, the requirements of section 112(g)(1)(D) of the 1939 Code would not have been met. In this connection, it is understood that for advance ruling purposes, the Internal Revenue Service considers that 50 per cent continuity of interest is required in connection with statutory mergers or consolidations.

Recent Revenue Ruling

If the Technical Information Releases mentioned above have caused confusion, that confusion has been confounded by the publication of Rev. Rul. 61–156 (IRB 1961–34, page 10). The latter revoked Rev. Rul. 56–541, but it is not to be applied retroactively in any case in which transactions were consummated prior to August 21, 1961, in reliance on the Service's position as set forth in Rev. Rul. 56–541. The facts on which the ruling was based and the conclusions stated follow.

Within a 12-month period a corporation adopted a plan of liquidation and sold "substantially all" of its assets to a corporation formed by "management." The consideration given by the acquiring corporation consisted of (a) 2.025 x dollars in shares of stock equal to 45 per cent of all the shares issued, (b) 4.975 x dollars in long-term rates, and (c) 11,000 x dollars in cash obtained through a first-mortgage borrowing on the assets acquired. Selling corporation dissolved, after payment of liabilities, distributing in exchange for its stock the 45 per cent stock interest, long-term notes and cash. The Service indicated that the transaction was essentially a "device" to distribute earnings, but that it was consummated "pursuant to a plan of reorganization." Then, citing *John A. Nelson Co. v. Helvering*, 296 U.S. 374 as authority for the proposition that there can be a "reorganization" even though the shareholders of the acquired corporation received less than half of the stock as the acquiring corporation, it was held that the transaction involved constituted "a reorganization within the meaning of section 368(a)(1)(E) and (F) of the Code."

A reference to *Bazley v. Comm.*, 337 U.S. 737, was made and it was held that the provisions of section 301, rather than section 356, were applicable, the ruling stating:

In this case, viewing the issuance of the stock of the "purchasing" corporation to the new investors as a transaction separate from the reorganization, it is concluded that the distribution to stockholders of the "selling corporation" of the cash, long-term notes and other assets *should be treated* as a distribution under section 301 of the Code. (Italics supplied.)

In the final analysis, Rev. Rul. 61–156 might be regarded as only a demonstration of the fact that the Service is likely to challenge any transaction on all-fours with the facts in that ruling, or in the ruling which is revoked thereby. Nevertheless, the many ramifications of this ruling warrant some analysis and comment.

It would seem that some principles enunciated or inferred may be germane in other circumstances which are not essentially the same as described in the revenue ruling. For instance, a transaction involving a transfer of assets to a newly organized corporation is held to be in substance a "recapitalization." Heretofore, that term has been regarded as applying only to rearrangement of the capital and debt structure within the framework of an existing corporation. That view of the term was expressed by the Supreme Court in *Helvering v. Southwest Consolidated Corporation* [315 U.S. 194, 202 (1942)]. Since that time the courts have expressed various opinions as to the meaning of the term "capital structure," but none have questioned whether the "reshuffling" process should be limited to an "existing corporation."

Next, but also indicative of a "new look" is the treatment of the sale of stock to the public as being so separate and independent a transaction as to permit its disregard in the resolution of the problems at issue. This may ultimately be important in resolving problems in the section 351 area, as well as others. Often the "separateness" of sales leads to a tax controversy. The treatment of the sale as a "separate" transaction is seemingly requisite to the holding that an (F) reorganization occurred. Otherwise, there could not be a "mere change in identity, form, or place of organization." Dictum in the *Southwest Consolidated* case, *supra*, also affords some light on what is not an (F) reorganization.

An aspect of Rev. Rul. 61–156 which may have some significance in the reorganization area is that no "business purpose" for a reorganization was demonstrated, although it was stated that there was a plan of reorganization. There was a statement in the ruling that the transaction was a "device" whereby it had been attempted to withdraw corporate earnings at capital gain rates. The mention of the Supreme Court's decision in the *Bazley v. Comm.* case in connection with the conclusion reached in the revenue ruling is mystifying. The Court in that case said that

Congress had not attempted to define a "recapitalization" and it would follow the example of Congress, making these observations: "No doubt there was a recapitalization in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books," and "What is controlling is that a new arrangement intrinsically partake of the elements of a reorganization which underlie Congressional intent and not merely give the appearance of it to accomplish a distribution of earnings." A further pronouncement by the Court shows quite definitely that a mere "paper recapitalization" is *not* a statutory reorganization. The exact language used by the Court which has been regarded as establishing with finality what a "recapitalization-reorganization" is not was as follows: "A 'reorganization' which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under section 112. This disposes of the case as a matter of law, since the facts as found by the Tax Court bring them within it. And even if the transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under section 112(c) (1) and (2) (*Commissioner v. Estate of Bedford*, 325 U.S. 283, Ct.D. 1641 C.B. 1945, 357)."

In view of the principles enunciated in that decision, it is difficult to see how *Balzey v. Comm.* affords any authority for the conclusion that a statutory reorganization occurred if the motivating purpose was to escape tax on distribution of earnings or for holding that section 301, rather than section 356, was applicable. (Note the Supreme Court said that 1939 Code section 112(c) (1) and (2) would have been applicable if there had been a "reorganization.")

The disturbing question which arises from analysis of this ruling is whether tax consequences may be changed by the Commissioner's waiver of judicial requirements for a statutory reorganization. Where reasons for conclusions expressed in a ruling appear on the face to be contrary to interpretations of law by the Supreme Court, it can be expected that they will be challenged. Is it suggested from conclusions stated in the revenue ruling that the lack of a business purpose is not relevant? If such a philosophy is to prevail, many shareholders will accept it with alacrity.

Significance of Percentage of Continuity of Interest

As the transaction involved in the ruling had been fragmentized, the sale to the public having been treated as not an integrated step in reaching the desired end result, it would logically have followed that, at the point deemed crucial by the Service, the shareholders of the "selling" corporation owned 100 per cent of the stock of the purchasing corporation. However, it must be presumed that there was pertinency to the discussion of the percentage of continued interest required in a reorganization. We must, therefore, endeavor to appraise that discussion in the context of the problems at issue and, if possible, find out the relevancy where the problem is to decide whether a given transaction will constitute a "reorganization" as defined by paragraphs (E) and (F) of section 368(a) (1) of the Code.

It was stated in part: "A surrender of voting control, or ownership of less than 80 per cent of the stock of a newly formed corporation, does not of itself mark a *discontinuity of interest*" (emphasis added). The case of *John A. Nelson Co. v. Helvering*, 296 U.S. 374, was cited as standing for the principle that even though the shareholders of the acquired corporation "received less than half of the stock of the acquiring corporation and received only nonvoting preferred stock therein" there was a reorganization. It was stated further: "It is necessary only that the shareholders continue to have a definite and substantial equity interest in the assets of the acquiring corporation." The Supreme Court was interpreting the general term "merger or consolidation" used in section 203(h) (1) (A) of the Revenue Act of 1926, not the terms, "a recapitalization" or "a mere change in identity, form, or place or organization, however effected." The discussion in the revenue ruling of the principle enunciated in the *Nelson* case, *supra*, provides an inference that an (F) reorganization may occur despite the fact that the shareholders' 100 per cent interest is reduced to an interest which is only "definite and substantial." However, to permit "continued equity interest" less than control to result from an (F) type of reorganization would clearly be inconsistent with Congressional purpose as indicated by sections 381 and 382 of the Code. The operating rules laid down in subsection 381(b) are not applicable to that type of reorganization; nor are the provisions of subsection 382(b) (1) requiring certain reductions in loss carry-overs applicable. Those provisions are in harmony with the commonly accepted concept of section 368(a) (1) (F), and it would probably be of no avail to cite the *Nelson* case, *supra*, in

contending for the purpose thereof that an (F) reorganization occurred if there had been merely a "definite and substantial continuing proprietary interest in the assets of a transferor."

The relevancy of the principle enunciated in the *Nelson* case, *supra*, in this particular context is difficult to ascertain. At any rate, it is doubtful whether the discussion of that case and the required percentage of continued proprietary interest will be illuminating in resolving reincorporation issues.

Treatment of Boot

Whatever importance may or may not attach to other portions of Rev. Rul. 61–156 in settling other issues, the treatment of the distributions of "other property," which occurred in connection with the transaction, as dividends within the concept of section 301 of the Code rather than "boot" governed by section 356(a) (2) will certainly become important. The conclusion of necessity hinged upon the distribution to the shareholders and the "reorganization" not being interdependent.

Even though such conclusion might not of itself cause concern, the premise therefor cannot fail to be provocative of thought. We will note that the explanation of the provisions of section 356(a) (2) and section 301 was followed by this language: "In this case, viewing the issuance of the stock of the 'purchasing' corporation to new investors as a transaction separate from the reorganization, it is concluded that the distribution to the stockholders of the cash, long-term notes, and other assets should be *treated* as a distribution under section 301 of the Code." (Emphasis added.)

The intimation that the applicability of section 301 was determinable by reference to the separateness of the transaction which had to be disregarded in resolving the reorganization problem presents an enigma. This was a matter of such paramount importance that an explanation of the inter-relation of the two factors would have been beneficial. Admittedly, the line of demarcation is very thin between the areas covered by section 301 and that governed by section 356(a) (2), but may such a line be drawn with reference to one that had been erased from a picture? A step-by-step extension of the theory, seemingly espoused by the ruling, could be accomplished without any perceptible violence to logic so that ultimately the provisions of section 356(a) (2) would be completely vitiated.

Significance of Revocation of Revenue Ruling 56–541

A final point relates to the revocation of Rev. Rul. 56–541 on account of the similarity of "circumstances." It would seem that it will be of no avail to demonstrate that an acquiring corporation was not the "brain child" of shareholders or even persons related to shareholders of the selling corporation. The "management" of the selling corporation, involved in the recent ruling, formed the "purchasing corporation," and they must have formulated the plan of action. But not so in the case covered by Rev. Rul. 56–541. There the unrelated parties seemed to have been the ones who formulated the plan. The participation of the old shareholders was not shown to have been motivated by the purpose proscribed by the recent ruling.

Of further interest is the fact that in the one case the shareholders of the old corporation could, under the Service's interpretation of the facts, have been deemed to have "control" at a crucial moment. Emphasis was placed on the "separateness" of the sale of stock to the public. Under the facts in the revoked revenue ruling, it is hard to find that the old shareholders could have been deemed to have control of the transferee at any crucial moment. Nevertheless, that ruling no longer represents the Service's views.

The interdependency of steps is determinable only in the light of all the facts and circumstances. It may be, therefore, that we shall ultimately find that only slight deviations in patterns, motivations on the part of the persons selecting the pattern, and the identity of those persons will be considered significant in this area. In view of the Supreme Court's decisions in *Court Holding Co.*, 324 U.S. 331; 65 S.Ct. 707, and *Cumberland Public Service Co.*, 338 U.S. 451; 70 S.Ct. 280, the one being quite different from the other by reason of the timing of the steps in the transactions, this reasoning seems sound.

Conclusion

In conclusion it is only safe to say that taxpayers and their advisors must proceed with caution in formulating plans in the situations discussed. Until some valiant souls, disinclined to co-exist with status quo, succeed in litigation, the examining officers will regard this field as fertile soil.

Undervaluation of Inventories

By Raymond E. Graichen

President Kennedy in his Tax Message to Congress on April 20, 1961 said the following with respect to inventories:

> "...It is increasingly apparent that the manipulation of inventories has become a frequent method of avoiding taxes. Current laws and regulations generally permit the use of inventory methods which are acceptable in recognized accounting practice. Deviations from these methods, which are not always easy to detect during examination of tax returns, can often lead to complete nonpayment of taxes until the inventories are liquidated; and, for some taxpayers, this represents permanent tax reduction. The understating of the valuation of inventories is the device most frequently used.
>
> "I have directed the Internal Revenue Service to give increasing attention to this area of tax avoidance, through a stepped-up emphasis on both the verification of the amounts reported as inventories and an examination of methods used in arriving at their reported valuation."

Secretary of the Treasury Dillon on May 3, 1961 explained the subject more specifically to the House Ways and Means Committee, making it clear that the government was concerned not only as to valuation methods but also as to the accuracy of physical count. The Commissioner of Internal Revenue on May 5, 1961 issued a Technical Information Release (TIR-317) stating in part:

> "Examining personnel have been instructed to place increased emphasis on examination of tax returns involving inventories and to give particular attention to inventory reserves, valuation methods, omission of inventory items, and allocation of costs. . . ."

The situation suggests that industry review its inventory counting and valuation procedures (valuation referring to the inclusion of direct labor and factory overhead as well as direct materials in the case of manufacturers and processors) to make certain they produce accurate results for income tax purposes. At the same time it is important to bear in mind that a taxpayer as a general rule may not change any of its established valuation methods unless permission to do so is obtained from the Commissioner of Internal Revenue. The Treasury's position is that this rule applies even though the methods employed may be erroneous.[1] Under this concept, erroneous methods consistently applied constitute accounting methods for tax purposes and because of relief provisions in the Code[2] it is often desirable to let the government initiate the change, rather than for the taxpayer voluntarily to request permission to switch to a correct method.

Inventory Ground Rules

Taxpayers are required to take into account inventory at the beginning and end of the year in order to determine correctly taxable income,[3] and to properly reflect the existence of an asset in reporting financial position.[4] Inventory determination ordinarily involves two steps, (1) physical count of *all* items owned by the taxpayer, regardless of where located and regardless of condition, and (2) valuation of each of those items. Physical count includes a written listing or tabulation identifying the kind and quantity of all inventory items which together with the computed valuation is required to be preserved as a part of a taxpayer's accounting records.[5] Valuation of inventory requires that all goods be identified either as (1) normal goods or (2) abnormal or subnormal goods, having reference to goods which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes. Normal goods must be valued in accordance with the established method or methods employed by the taxpayer, whereas goods not salable or usable in the normal or ordinary course of business should be valued at bona fide selling prices less direct cost of disposition, but in no event less than scrap value.[6]

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Practices Not Permitted

Although sometimes employed, the following practices or methods are *not* permissible for tax purposes:[7]

1—Deducting from or reducing inventory value by a reserve for price changes, obsolescence, depreciation, etc. (There is no statutory provision in the Code which permits inventory reserves of any kind.)

2—Valuing work in process or other parts or segments of inventory at a nominal price or at less than a proper value. (See permissible valuation methods discussed hereinafter.)

3—Omitting from inventory portions of the stock or goods on hand. (Physical count must include *all* inventory.)

4—Using a constant price or nominal value for so-called "base stock" or normal quantity of inventory. (See permissible valuation methods discussed hereinafter.)

5—Including in inventory stock in transit, title to which is not vested in the taxpayer. (Inventory includes only goods actually owned by the taxpayer.)

Where a taxpayer engages in any of these practices or methods for tax purposes, a correction or change would apparently be governed by change of accounting method rules.[8] At the present time it is understood that the Commissioner has taken a stand that a change in an erroneous method on the books requires a corresponding change for tax purposes. Under this circumstance, taxpayers who wish to correct their financial statements although not make any change taxwise should proceed with caution. Perhaps it might be possible to correct the financial statements without changing the books.

Permissible Inventory Valuation Methods

With respect to normal inventory there are three basic valuation methods, (1) cost, (2) cost or market, whichever is lower, and (3) market value (the use of which, however, is restricted to certain taxpayers[9]). Uniform rules governing the selection of these methods are not prescribed except that the method or methods selected must conform to the best accounting practices in the trade or business and they must clearly reflect income. Consistency from year to year carries greater weight than the particular method selected.[10] But whatever method is selected, whether permissible or otherwise, it constitutes an accounting method for tax purposes.[11]

Cost

For tax purposes[12] cost means (a) in the case of goods on hand which were also on hand at the beginning of the year, the inventory value of such goods at the close of the preceding year, and (b)

in the case of goods on hand which were purchased or produced during the year, the actual cost thereof paid or incurred during the year. As to manufacturers and producers, cost consists of three elements (1) raw materials becoming a part of or consumed in connection with the product, or "direct materials," (2) labor applied to the direct materials, or "direct labor," and (3) indirect or "overhead" expenses incident or necessary to production.[13]

Indirect Production Expense (Overhead)

Various methods of absorbing production overhead in inventory are practiced by manufacturers and producers and this represents a complicated subject in itself. One application in particular, referred to as the "direct cost method," deserves mention. Under this method fixed items of overhead, such as depreciation, real estate taxes, etc., are charged to "period" or current year expense and are not included in the total overhead allocated to and absorbed in inventory. It appears this method may be acceptable for tax purposes if adopted at the time a taxpayer is faced with the valuation of his first inventory, provided the method is used on the taxpayer's books as well as in his tax return.[14] The regulations state ". . . the extent to which indirect costs shall be included . . . depends upon the method used by the taxpayer in treating such items in keeping his books . . ."[15] Adoption of this method at the beginning is significant since at the present time the Commissioner of Internal Revenue will not permit a change from a "full" absorption method to the direct cost approach.

Standard Costs

Concerning the definition of "cost" the income tax regulations intend the term to mean "actual" cost. Therefore, the use internally of "standard costs" in valuing inventory may lead to serious differences between the taxpayer and the government if the standards are substantially different from actual cost.

Trade Practices of Approximating Cost

In a few industries trade practice has established methods which result in "approximate" cost valuations. Certain of these methods are acceptable and are deemed by the regulations to be cost methods.[16] They include the "retail method" employed by retail merchants, under which the inventory is taken at selling price and then reduced to approximate cost by application of gross profit ratios,[17] and the "unit-livestock-price method" used by

livestock raisers and farmers, in which case the taxpayer is permitted to approximate the cost of raising or producing his animals.[18] Another acceptable trade practice concerns those industries which by a single process or a uniform series of processes derive two or more kinds, grades, or sizes of products. In that case it is permissible to allocate total cost to the different products on the basis of their relative selling prices.[19]

LIFO

The last-in, first-out method[20] of inventorying is a cost valuation method. Under this method a taxpayer is permitted to disregard the identity of goods on hand at the end of the year as to when they were purchased or produced and to treat them first as those goods on hand at the beginning of the year and, secondly, with respect to new goods or increased quantities as those purchased or produced during the year. The purpose of LIFO is to freeze a selected cost level for valuing subsequent inventories, with increases in inventory taking the cost level of the year of increase.

Cost or Market, Whichever Is Lower

Under the lower of cost or market method,[21] the cost of each item of inventory is compared with the market value and the lower of the two values is the proper inventory value. This method is the most commonly used because it is a conservative application which recognizes inventory losses when they occur, regardless of when the inventory is sold.

Under ordinary circumstances "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which the taxpayer usually purchases. In the case of purchased goods, market means the replacement price. In the case of manufactured goods, it means the reproduction cost or the necessary amounts of material, labor and overhead at current rates to bring the item to a comparable state of completion. If the item has reached a salable state, market value may be substituted if it is less than reproduction cost.[22]

Market

Market[23] value as a basis for inventory valuation is permitted only in the case of dealers in securities and certain commodities and by livestock raisers and farmers. The cost and the lower of cost or market methods are both available to such taxpayers,

although past experience has indicated that they frequently find it more convenient to employ a market valuation. Securities and commodities dealers apply a straight market valuation whereas livestock raisers and farmers reduce the market value by the direct cost of disposition. The market value approach in the case of livestock raisers and farmers is referred to as the "farm-price method."

Accounting Method Rules and Inventory Valuation

Prior to 1954 a great deal of conflict had occurred with respect to accounting methods, with the majority of the cases involving inventory. The taxpayer was pitted against the Internal Revenue Service and the Internal Revenue Service, against the courts, and the courts themselves did not agree. Consequently, Congress in 1954 stepped in, expanded the statutory provisions with respect to accounting methods[24] and enacted new legislation prescribing the tax consequences attending a change of accounting method.[25] The dispute centered around three points, (1) definition of the term "accounting method," (2) conditions under which a taxpayer may change his method of accounting, and (3) adjustments to income which are necessary when a taxpayer changes from one method to another. Congress attempted to resolve all three points.

Definition of Accounting Method

Under the income tax regulations applicable to taxable years after 1953, the term "method of accounting" is defined as follows:

> "... The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. . . ." [26]

Under this definition, the accounting treatment accorded *every* item of gross income and deduction from year to year for tax purposes constitutes an accounting method. The definition is derived from the Congressional minutes relating to 1954 Code Sections 446 and 481, and it is abundantly clear that the method of valuing inventory is within the definition. The Congressional minutes disclose:

> ". . . A change in the method of accounting includes a change in the general method of accounting. . . . It also includes a change in the treatment of a material item such as a change in the method of valuing inventory. . . ." [27]

Therefore, it follows that all rules governing accounting methods apply with full force to practices and methods of valuing inventory.

Conditions Precedent to Change of Method

The confusion in the accounting method arena under the 1939 Code (years prior to 1954) was caused in no small part by a paucity of statutory provisions and of regulations on the subject. Notwithstanding this situation, the Courts usually came to the conclusion that "consistency" was required of the taxpayer unless the Commissioner gave his consent to a change or unless there was a specific statutory provision which allowed a change without permission:[28]

> ". . . Consistency is the key and is required regardless of the method or system of accounting used. . . ."

Under this approach, once a taxpayer adopted an accounting method with respect to an item of gross income or deduction, regardless of whether the adopted method was correct or incorrect, the taxpayer was required to be consistent thereafter. Some decisions,[29] however, indicated disagreement with this approach.

Congress, in enacting the accounting method sections 446 and 481 of the 1954 Code, has made consistency "mandatory" and a change of method is not now possible unless (1) a specific statutory provision permits the change without the Commissioner's consent, (2) the Commissioner gives his consent to the change, or (3) the item involved in the change is not "material." The rule in force since 1954 is embodied in the following regulation:[30]

> ". . . A change in the method of accounting includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured. . . ."

This regulation is also derived from the Congressional minutes relating to the enactment of Sections 446 and 481 of the 1954 Code. Those minutes state:[31]

> ". . . A taxpayer who changes his general method of accounting or who treats material items inconsistently must obtain the consent of the Secretary or his delegate unless an express provision of this chapter permits such change at the election of the taxpayer without consent. . . ."

It seems to this author that the only doubt remaining in the above rules concerns the term "material." That term is not defined for tax purposes and it is not likely that the definition for financial accounting purposes will be acceptable. Even in the latter case "materiality" is not perfectly defined. Under the cir-

cumstances it seems advisable to approach basically all changes in accounting methods for tax purposes as being material in nature, with the result that if a change is not available by reason of a specific statutory provision it becomes necessary to request the permission of the Commissioner to make the change. A new standard form, Form 3115, has been provided for this purpose. This form must be filed during the first 90 days of the taxable year in which the change is to be effective.

As to valuation of inventory it seems apparent that all consistently applied practices employed by a taxpayer in determining the value of items of inventory constitute accounting methods, and, indeed, even though erroneous they may not be changed for tax purposes except under the conditions prescribed above. The *only* change in method of inventory valuation which may be made at any time without the Commissioner's consent is the change *to* the LIFO inventory method.[32] In addition, certain changes within the LIFO method are permitted either generally or for certain specified taxable years under the "dollar-value" LIFO regulations promulgated January 20, 1961.

Adjustments Attending a Change of Accounting Method

Perhaps the most "heat" generated by 1939 Code disputes over changes of accounting methods concerned the tax consequences of changing from one method to another, particularly when the former method was an erroneous method. It was here that taxpayers, the Commissioner and the Courts went in all directions. The question was—did the Commissioner have a right to tax in the year of change the income which under the correct or newly adopted method of accounting should have been reported in prior years now closed by the statute of limitations? Frequently, the mitigation of limitations provisions came into play for the injured party especially where inventory was involved.[33] To end these problems, Congress enacted Section 481 in the 1954 Code.

If an accounting method change is made in any taxable year after 1953, Code Section 481 governs and prescribes all of the adjustments necessary "to prevent amounts from being duplicated or omitted." The underlying purpose of the section is to control in particular the necessary adjustments attending the correction of an erroneous method to a correct method. The following was contained in the Congressional minutes at the time of the enactment of Section 481 in 1954:[34]

"...Your committee felt that permitting the entire adjustment would result, in effect in *adjusting for errors* which occurred during years when there was no statutory authority for making such adjustment....Therefore, your committee's bill provides that the portion of the net transitional *adjustment which corrects errors* made prior to 1954 will not be made. The transitional adjustments in all future changes under your committee's bill will be those resulting from a change in accounting method determined (under the facts) to be necessary to *adjustment for erroneous treatment* of items subsequent to 1953...." (Italics added)

In its original form, Section 481 excluded from the required transitional adjustment all income and deductions attributable to pre-1954 years. The Treasury resisted this exclusion and as a result Congress in 1958 amended the new provisions retroactively so that the pre-1954 exclusion or exemption is applicable only when the accounting method change is initiated by the Commissioner. The following excerpt is from the Congressional minutes at the time of the amendment in 1958:[35]

"... Section 481 of the 1954 Code *for the first time* provided statutory rules with respect to these adjustments. This section requires these adjustments to be made in full to the extent that they are attributable to 1954 or a subsequent year. However, no adjustments are required which are attributable to years before the application of the 1954 Code.

"...The House report suggests that there is no reason why the pre-1954 Code years adjustments should not be made, when taxpayers, of their own volition, have changed their method of accounting." (Italics added)

Accordingly, the rule under Section 481 is that if a taxpayer today initiates a change of an erroneous accounting method he must *in the year of the change* report the net amount of all income and deductions attributable to prior years under the correct or newly-adopted method of accounting to the extent that such income and deductions were not reported by reason of the use of an erroneous accounting method. It is immaterial that the prior years may be closed under the statute of limitations—omitted income and deductions of *all* prior years are reported in the year *in which the change of accounting method is made.* The Code therefore permits, indeed requires, the "bunching" of income in the year of change. Some relief is given in the form of special tax computations for the year of change and also in the form of an optional 10-year spread-forward of that portion of the current year adjustment which represents pre-1954 income.[36] The optional spread-forward is not available for accounting method changes after 1963. The only *exemption* of prior years' income available is when the Commissioner, rather than the taxpayer, initiates the

change of accounting method. In that case the omitted income and deductions attributable to pre-1954 years are excluded from the current year adjustment.

The mechanics of Section 481 require that for the year of change of accounting method the taxable income must first be computed on the basis of the correct method of accounting. The next step is to determine the adjustments necessary to prevent duplication or omission, and the quickest way to do this is simply to compare the opening tax basis balance sheet under the correct accounting method with the opening tax basis balance sheet under the erroneous method. The net difference in balance sheet accounts having an effect upon taxable income represents the "net adjustment" under Section 481. The net adjustment, if it represents additional income, is added to the income determined under Step 1. If the net adjustment represents a deduction, it is deducted from the income determined under Step 1. The result is taxable income for the year of the accounting method change, unless, of course, the taxpayer elects a spread-forward with respect to the pre-1954 income portion of the net adjustment. The spread-forward is not available if the net adjustment represents a deduction.

To illustrate the foregoing with respect to correction of an erroneous method of valuing inventory, assume that a calendar year taxpayer has been in business for many years and has consistently employed an erroneous method of valuing inventory. A change to a correct method is made during 1960. The necessary facts to apply Section 481 are as follows:

	Inventory Value	
Inventory Date	*Erroneous Method*	*Correct Method*
December 31, 1953	$100,000	$150,000
December 31, 1959	140,000	200,000
December 31, 1960	180,000	300,000

Assuming the taxpayer initiated the change and obtained the Commissioner's consent as required by the rules, the taxable income for 1960 would be computed first by using an opening inventory of $200,000 and a closing inventory of $300,000. To the income so determined a "net adjustment" of $60,000 would be added, since the net adjustment represents additional income. Optional spread-forward provisions would be available with respect to $50,000 of the $60,000. The net adjustment of $60,000 is the

amount of income omitted in prior years and is simply the excess of the correct inventory value over the erroneous value at the beginning of the year ($200,000 less $140,000). The portion of the net adjustment attributable to pre-1954 years would be the difference between the correct and the erroneous inventory values at December 31, 1953 or $50,000 ($150,000 less $100,000). If the Commissioner, rather than the taxpayer, initiated the change, the pre-1954 income of $50,000 would be exempt and the 1960 net adjustment would be limited to $10,000 ($60,000 less $50,000).

The above illustration demonstrates the *unimportance* of whether prior years' statutes of limitations are open or closed.

Penalty of Inconsistency or Change Without Permission

It is clearly stated in the regulations that the term "method of accounting" includes not only the over-all accounting method but also the accounting treatment accorded every item of gross income and deduction. It is equally clear that any substantial inconsistency in the treatment of any item of gross income or deduction constitutes a change of accounting method and that a change of accounting method is not permissible without the Commissioner's consent unless there is a specific statutory provision allowing the change without permission. Therefore, if a taxpayer makes a change in violation of these rules he invites the wrath of the Commissioner. If a change is made without permission, it may or may not be permitted at the time the Internal Revenue Agent examines the tax return. In any event, allowance of such a change is entirely discretionary on the part of the Commissioner and it may well be that years after the change has been made the taxpayer will be required to return to his old method, even though the old method is erroneous.

As pointed out previously, consistency is mandatory.[37] An erroneous method consistently applied may as a matter of fact clearly reflect income, in which case the Commissioner has the authority to approve the continued use of the erroneous method:[38]

"... the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the Income Tax Regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. . . ."

Mitigation of Limitations, Sections 1311–1315

The basic purpose of the mitigation of limitations provisions is to permit the opening of the statute of limitations with respect to a closed year to prevent either the taxpayer or the government

from profiting taxwise from inconsistency. It is believed in some quarters that the government will attempt to employ the mitigation of limitations provisions to overcome the pre-1954 income exclusion provided by Section 481 when the government, rather than the taxpayer, initiates a change or correction of an inventory valuation method. It might appear that Revenue Ruling 58–327[39] gives credence to this belief. The summary of that ruling states:

"Inventories constitute items of gross income within the meaning of Sections 1311 to 1315 inclusive, of the Internal Revenue Code of 1954, or Section 3801 of the Internal Revenue Code of 1939, relating to the mitigation of effect of limitations and other provisions with regard to items affecting taxable income."

A careful study of this ruling discloses that it involves taxable years prior to the time Section 481 became effective and, as well, the issue does not relate to adjustments attending a change of consistently applied accounting method. Accordingly, there is no apparent conflict between this ruling and Section 481. It may be that the situation requiring adjustment was caused by a nonrecurring year-end inventory pricing error. It follows that this ruling would complement or supplement rather than conflict with Section 481.

In this author's opinion, Sections 1311 to 1315 have no application to correction of an erroneous accounting method. Section 481 prescribes the necessary adjustments to correct for prior-year error, and it precludes the necessity of opening closed years by *requiring* that the amount of prior-year error be reported *in the year of the accounting method change.* Contrary to 1939 Code provisions, Section 481 permits, indeed requires, the bunching or distortion of income for the year in which the accounting method is changed or corrected.

NOTES

1. Regs. 1.471–2 (d) and 1.446–1 (e).
2. I.R.C. 481.
3. Regs. 1.471–1.
4. Montgomery's Auditing, 8th Edition, Page 192.
5. Regs. 1.471–2 (e).
6. Regs. 1.471–2 (c) and (d).
7. Regs. 1.471–2 (f).
8. I.R.C. 446 and 481.
9. Regs. 1.471–2 (c).
10. Regs. 1.471–2 (a) and (b).
11. Regs. 1.471–2 (d).

12. Regs. 1.471–3.
13. Montgomery's Auditing, 8th Edition, Page 194.
14. *Geometric Stamping Co.*, 26 TC 301 (A).
15. Regs. 1.446–1 (c) (ii).
16. Regs. 1.471–2 (c).
17. Regs. 1.471–8.
18. Regs. 1.471–6.
19. Regs. 1.471–7.
20. I.R.C. 472.
21. Regs. 1.471–4.
22. G.C.M. 9401, X-1 CB 102; cf. *Bedford Mills, Inc.*, 2 Fed. Supp. 769, cert. den. 290 U. S. 655.
23. Regs. 1.471–5 and 1.471–6.
24. I.R.C. 446.
25. I.R.C. 481.
26. Regs. 1.446–1 (a) (1).
27. Senate Committee Report, 83rd Congress, 2nd Session, Report No. 1622, Page 300 (1954).
28. *Advertisers Exchange, Inc.*, 240 Fed. 2d, 958.
29. *Beacon Publishing Co.* 218 Fed. 2d, 697; *American Can Co.* 37 T.C. #26.
30. Regs. 1.446–1 (e) (2) (i).
31. Senate Committee Report, 83rd Congress, 2nd Session, Report No. 1622, Page 300 (1954).
32. I.R.C. 472.
33. 1939 Code Section 3801 (1954 Code Sections 1311–1315).
34. Senate Committee Report, 83rd Congress, 2nd Session, Report No. 1622 (1954).
35. Senate Committee Report, 85th Congress, 2nd Session, Report No. 1983 (1958).
36. I.R.C. 481 (b).
37. *Advertisers Exchange, Inc.*, 240 Fed. 2d, 958; *Ross B. Hammond*, 97 Fed. 2d, 54; *St. Paul Union Depot Co.*, 123 Fed. 2d, 235; *Brown v. Helvering*, 291 U. S. 193; *Schram*, 118 Fed. 2d, 541.
38. Regs. 1.446–1 (c) (2) (ii).
39. C.B. 1958–1, 316.

Walter A. Staub*

By William J. Neary

Walter A. Staub, President of The New York State Society of Certified Public Accountants in 1933 and 1934, was during his forty-five year career in public accounting one of that distinguished group whose tireless and unselfish devotion to the advancement of the accounting profession has helped to bring it to its present level of competence, dignity and public service.

As a boy in his native city of Philadelphia, his road was not an easy one. Born on February 27, 1881, he was not yet five years of age when his father died. The family lived in very modest circumstances. At the age of nine he was admitted to Girard College, a school for fatherless boys founded by the merchant and philanthropist, Stephen Girard. He graduated with honors in 1897. This terminated his formal education but with a strong desire for knowledge he continued to study on his own. Throughout his life he maintained an active interest in Girard College and in 1934 was the recipient of the Stephen Girard Award as one "whose outstanding qualifications in his chosen field of activity reflect credit and honor upon Girard College."

After graduation he took a position in the office of an electrical contractor and, in 1899, became an assistant to the accountant for the Girard Estate. In 1901, he came to the attention of Robert H. Montgomery who, three years earlier had, in association with William M. Lybrand, T. Edward Ross and Adam A. Ross, founded the firm of Lybrand, Ross Bros. & Montgomery in Philadelphia. Mr. Montgomery was impressed with the accounting knowledge and the mature judgment of this young man of twenty. In short order, Walter Staub became associated with the new firm, an association which was to last until his death almost forty-five years later.

The firm of Lybrand, Ross Bros. & Montgomery grew quickly and in 1908 Mr. Staub was assigned to set up and manage a new office in Pittsburgh. In 1911 he became a partner, the second partner to be admitted to the firm since its founding. At that time he assumed charge of the Chicago office. In 1914 he transferred to New York and was a resident partner there until his death.

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*Ed. Note—*This biographical recollection is one of a series which we intend to include from time to time, covering a number of the key figures in the Firm's development.*

In 1903, Mr. Staub passed the Pennsylvania CPA examination and received his certificate. In later years he became certified in a number of other states, including New York.

In 1904, the first International Congress of Accountants was held in St. Louis. Mr. Staub won the prize offered by the Congress for the best paper by a clerk in an accountant's office on "The Mode of Conducting an Audit." It is noteworthy that in 1943 his winning paper was reprinted in *The Accounting Review* "because of its historical interest as the earliest authoritative description of the typical American audit program." This was the first of his many contributions to the literature of accounting. His "Income Tax Guide" which dealt with the Act adopted on October 3, 1913 was published in that year and was one of the first books written on federal income taxes. He contributed many articles to the *Journal of Accountancy, The New York Certified Public Accountant* and other publications on accounting and allied subjects. His contribution to the "Proceedings"—International Congress on Accounting held in New York in 1929, entitled "Consolidated Financial Statements" was later published in book form. He was a co-author of the books "Auditing Principles" published in 1924 and "Wills, Executors and Trustees" published in 1933.

Walter A. Staub was selected by the President and Fellows of Harvard College on recommendation of the Graduate School of Business Administration of Harvard University: ". . . a man recognized as outstanding in accounting, to serve for the academic

WILLIAM J. NEARY *is a manager in the Firm's New York audit division. He was graduated* (magna cum laude) *with a B.S. degree from N.Y.U. and holds a New York state certificate. He is a member of the American Institute, the New York State Society of CPAs, and the Accountants Club. Mr. Neary, his wife and four daughters live in Crestwood, New York, where he is a member of the Board of Directors and Treasurer of the Larchmont Shore Club. The above biography on Mr. Staub first appeared in* The New York Certified Public Accountant *and was prepared for the Society's Committee on History.*

year 1940–41 as the fourth Dickinson lecturer under the foundation established in acknowledgment of the debt of the accounting profession to Sir Arthur Lowes Dickinson." In August, 1945, a few months before his death, his excellent paper "Significance of the Balance Sheet—What Is Book Value?" was written for *The New York Certified Public Accountant.*

In addition to serving two terms as President of the New York State Society, he was First Vice President from 1930 to 1933 and also served as a Director. He was from 1941 to 1944 Chairman of the Committee on Accounting Procedure of the American Institute of Accountants. In 1935 he was Chairman of the joint committee appointed by the American Institute and the American Society of Certified Public Accountants to work out the plan which eventually resulted in the merger of the two organizations. As a recognized authority in the accounting and tax fields, Mr. Staub was much in demand as a speaker at meetings of various accounting societies, the Controllers Institute, the Practicing Law Institute and similar organizations.

Although he gave unsparingly of his time and efforts for the welfare of the accounting profession, he found time for other activities. He served four elective terms on the Millburn, New Jersey, Board of Education from 1924 to 1936, the last several years as President. He was also Chairman of the Finance Committee of the Northern Baptist Convention and President of the Board of Trustees of Overlook Hospital in Summit, New Jersey.

Travel was Mr. Staub's chief form of relaxation. His interest in history led him to make numerous trips to Europe. He also traveled extensively in this country and Canada and to Hawaii. In sports, he enjoyed tennis and maintained a court at his home in Short Hills, New Jersey, where he lived with his wife, five sons and two daughters. Two of his sons are now partners in the firm of Lybrand, Ross Bros. & Montgomery.

Mr. Staub died suddenly on November 4, 1945 while on an overnight trip to his native city of Philadelphia. His passing left a void in his firm and in his profession. Nothing could better describe him nor express more clearly the loss felt upon his death than the following excerpt from a letter of tribute from one of the clients of his firm:

"It would be well nigh impossible for me to adequately express my deep regard for the high qualities of mind and heart with which his personality was endowed—he was indeed a rare character. He possessed in an unusual degree the most delightful

faculties one could wish for—the faculty of subjecting a problem to a calm, dispassionate and highly intelligent analysis which gave to his judgment a quality that immediately won the admiration and support of his clients and his friends who detected and invariably appreciated the background of his broad experience and knowledge.

"His endearing traits within a sterling character of the strictest personal integrity, provide a memory which will endear him and make that memory beloved by all who knew him."

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Speaking Engagements

(The Speaking Engagements listed below cover the quarter July 1 through September 30, 1961.)

Date	*Speaker*	*Organization*	*Topic*
July			
10	Joseph E. Tansill, Chicago	Rotary Club, Kalamazoo, Michigan	Recent Developments in Federal Taxation
10–14	Herman C. Heiser, New York	AMA, New York	Chairman, Seminar—Profit Planning with Budgetary Control
10, 11, 12	Frederick P. Sloat, Terriberry	AMA Workshop Seminar	Resource Leader—Modernizing the Pension Plan
18	John W. Johnson, Los Angeles	Career Research Class, John Adams Junior High School, Santa Monica	Accounting as a Profession
20	David A. Biasotti, C. John McDowell, San Francisco	California Society of CPAs, San Francisco Chapter, Accounting and Auditing Procedures Committee	Discussion Leaders — Two case studies involving current problems in accounting and auditing practice
27	A. Sapega, New York	Air Force Institute of Technology, Wright Patterson Air Force Base, Columbus, Ohio	Feasibility Studies
31 and Aug. 1, 2	A. Sapega, New York	AMA Academy, Saranac Lake, New York	Group Leader—Fundamentals of Data Processing for Non-data Processing Executives
Aug.			
3	Felix Kaufman, New York	AMA, Saranac Lake, New York	Role of Management Sciences in EDP
7	J. Paul Finnegan, Boston	Colby College, Waterville, Maine	How to Handle Travel, Entertainment and Moving Expenses, and Reporting Requirements and Proposed Legislation
8	J. Paul Finnegan, Boston	Colby College, Waterville, Maine	Discussion co-leader—Trust Operations and Administration
10	James E. Hammond, San Francisco	AICPA, Staff Training Program, University of California, Santa Barbara	The Future of the Accounting Profession
12	Raymond J. Leisner, Cincinnati	Ohio Contractors Association, Summer Meeting, Mansfield	Adequate and Accurate Cost Information
15	Maurice B. T. Davies, Los Angeles	California Society of Accountants, Advanced Study Conference, Santa Barbara	Techniques and Procedures in Writing Audit Reports
20, 21, 22	A. R. Jennings, New York	California Society of CPAs, Graduate Study Conference, Santa Barbara	Discussion leader—General topics
21, 22	Claude R. Giles, San Francisco	California Society of CPAs, Graduate Study Conference, Santa Barbara	Discussion leader—Capital Stock and Equity Sections of the Balance Sheet; and Discussion leader—The Financial Statement: Differences Between Tax and Financial Accounting When Depreciation Is Employed
23	John W. Conrad, Chicago	School of Banking, University of Wisconsin, Madison	The Accountant's Role in Corporate Finance

Date	*Speaker*	*Organization*	*Topic*
Sept.			
24	Felix Kaufman, New York	AMA, Saranac Lake, New York	Role of Management Sciences in EDP
6	Louie M. Bradley, Los Angeles	California Society of CPAs, Los Angeles Chapter	Report on CPA Society Graduate Study Conference in Santa Barbara
6 7 8	William G. Casey, Boston	New England Graduate Study Conference Association, Dartmouth College, Hanover, New Hampshire	Discussion leader—Control, Through Cost Accounting
6 7 8	Bill Goodner, Birmingham	University of Georgia, Athens	Review of Developments During the Past Year Relating to Federal Individual Income Taxation
8	Felix Kaufman, New York	National Legislative Conference, Council of State Governments, Post Audit Workshop, Philadelphia	Effects of Electronic Data Processing on Internal Control
9	Maurice B. T. Davies, Los Angeles	Utah Association of CPAs, Annual Conference, Salt Lake City	The Conduct of an Accounting System Survey for a Small Business
9	Leo V. Tinkham, Chicago	North Carolina Association of CPAs, Chapel Hill	A Blueprint for Committees
11	David G. Fernald, New York	American Mining Congress, Mining Convention Tax Forum	Joint Operating Agreements
12	William R. Hindman, Chicago	Systems and Procedures Association, Louisville Chapter	Consultant's Role in Improvement Programs
12	James E. Meredith, Jr., Philadelphia	N.A.A., North Penn Chapter, Gwyneed	Organizing for Systems Study
12	William R. Wilson, Boston	Massachusetts Heart Association, Boston University	Theories and Systems of Accounting for Charitable Organizations
14	Harry C. Zug, Philadelphia	Accounting Study Conference, Pennsylvania State University	Professional Affairs
15	Roy H. Webster, Portland	Washington Society of CPAs, Sixth Northwest Graduate Accounting Study Conference, Victoria, B.C.	Discussion leader—Accounting Principles
15	G. W. Welsch, Dallas	First New Mexico Tax Institute, Albuquerque	Accountant's Role in Estate Planning
15 16	Herman Stuetzer, Jr., Boston	Northeastern University Tax Forum	Business Expenses
16	J. M. Conder, Dallas	Texas Society of CPAs, San Antonio Chapter	Statement Presentation
18	John L. Moneta, Philadelphia	Pennsylvania Institute of CPAs, Philadelphia Chapter	Financial Considerations in Buying or Selling a Business
19	Herman C. Heiser, New York	N.A.A., Birmingham Chapter	Profit Planning Through Budgetary Control
19	Felix Kaufman, New York	RCA 501 Users Association, Ordnance Weapons Command, Haddonfield, New Jersey	The Importance of Control in EDP
20	William R. Hindman, Chicago	N.A.A., Fox River Valley Chapter, Aurora, Illinois	Direct Costing
22	Maurice B. T. Davies, Los Angeles	California Society of CPAs, Los Angeles Chapter, Management Services Seminar	Organizing and Managing a Management Services Engagement
25	Sherman L. Harper, Carl M. Moser, Los Angeles	California Society of CPAs, Los Angeles Chapter	Panel members—Current Tax Developments (technical discussion)

Date	*Speaker*	*Organization*	*Topic*
Sept.			
25	H. O. Reyburn, Tulsa	Ohio Society of CPAs, Annual Convention, Akron	Debate member—Amendment to Rule 13
26	Alfred H. Hunt, San Francisco	The Salvation Army, Finance Officers	Modern Management Techniques
26	T. W. McKibben, Tulsa	Oklahoma Society of CPAs, Eastern Oklahoma Chapter, Muskogee	Auditing Nonprofit Institutions
27	Maurice B. T. Davies, Los Angeles	Institute of Internal Auditors, Los Angeles Chapter	Avoiding Pitfalls in Audit Reports
27	Raymond E. Graichen, Philadelphia	University of Pennsylvania Tax Conference	Pitfalls in Changes in Accounting Methods
27	Felix Kaufman, New York	National Retail Merchants Association, Chicago	The Role of Control in EDP
27	A. R. Ransom, Jr., Baltimore	Pennsylvania Motor Truck Association, Philadelphia	Break Even Charts
28	Andrew Sapega, New York	N.A.A., Philadelphia Chapter	Panel member—Concept Language and Equipment for the Smaller Data Processing System
29	Henry B. Jordan, Washington	University of Alabama, 15th Annual Federal Tax Clinic, University, Alabama	Tax Rulings and Tax Legislation
29	Ralph P. Kulzer, Pittsburgh	Pennsylvania Institute of CPAs, Pittsburgh Chapter	Violation of Rules of Professional Conduct by Pennsylvania CPAs
30	G. W. Welsch, Dallas	Fourth Annual Institute on Estate Planning, Abilene	Current Developments in Estate Planning

Professional Society Appointments

The following partners and members of our staff are serving as officers or members of committees for the year 1961–62:

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Members of Council

Elected Members

Mark E. Richardson	New York
Claude R. Giles	San Francisco
Mark C. Walker	Boston
Harry C. Zug	Philadelphia

Ex-Officio—Past President

Alvin R. Jennings	New York

Trial Board

George A. Hewitt	Philadelphia

Committees

Outside the Normal Committee Structure

Accounting Principles Board	Alvin R. Jennings, New York
Inter-American Accounting Conference Planning Committee	James J. Mahon, New York
International Congress Planning Committee	R. Kirk Batzer, New York
Relations with the Bar	John C. Potter, Detroit

Committees

Accounting and Auditing with Electronic Computers	Felix Kaufman, New York
Accounting and Office Equipment	John J. Fox, Detroit
Auditing Procedure (Chairman)	Philip L. Defliese, New York
Awards	Coleburke Lyons, Detroit
Banking	Donald J. Atwater, San Francisco
Education (Chairman, Relations with Universities)	Harry C. Zug, Philadelphia
Estate Planning	Norman E. Auerbach, New York
Ethics of Tax Practice	J. Paul Finnegan, Boston
Federal Taxation	
Corporations and Stockholders	William T. Barnes, Washington
Partnerships and Partners	Joseph Tansill, Chicago
Special Tax Problems (Chairman)	Herman Stuetzer, Jr., Boston
Insurance Accounting	Norman E. Cusworth, New York
Insurance Trust (Chairman)	Alvin R. Jennings, New York
International Relations	James J. Mahon, New York
Management of an Accounting Practice	Calvin H. Nelson, San Francisco
Management Services	Herman C. Heiser, New York
National Defense	Paul M. Whitman, Cincinnati

Personnel Recruiting	Leonard L. Hopkins, Columbus
Public Utilities (Chairman)	Walter R. Staub, New York
Relations with Bankers and Other Credit Grantors	Donald W. Schroeder, San Francisco
Relations with Securities and Exchange Commission and Stock Exchanges	Louis H. Rappaport, New York
Relations with State Societies	Robert S. Warner, Los Angeles
State Legislation	Mark E. Richardson, New York
Uniform Accounting Provisions of State Corporation Laws	Carl Simon, New York

Committees on Membership

Illinois	Lawrence Frazee, Rockford
Maryland	John A. Engel, Jr., Baltimore
Massachusetts	Vincent R. Collins, Boston
Ohio	Robert L. Herbert, Cleveland Katherine E. Pfeifer, Cleveland

ALABAMA SOCIETY OF CPAs

State Committees

Accounting Research	Fred Browning J. Henry Owen John F. Silton
16th Annual Tax Clinic (Co-Chairman)	Bill Goodner

ARIZONA SOCIETY OF CPAs

State Committees

Grievance Committee	Carl D. Tisor

CALIFORNIA SOCIETY OF CPAs

State Committees

Annual Meeting, 1962, Arrangements	Calvin H. Nelson
Program	J. Wesley Huss
Bylaws and Resolutions	Claude R. Giles
Cooperation with Credit Grantors (Chairman)	Milton J. Hoffman Donald W. Schroeder
Educational Standards and Student Relations (Vice-Chairman)	Frank Y. Garrison, Jr.
Governmental Accounting and Auditing	David H. Brodie
Graduate Study Conference	Louie M. Bradley
Insurance Plans	Milton J. Hoffman
Lawyer—CPA Mediation	Robert S. Warner
Legislation (Chairman)	J. Wesley Huss
Long Range Planning for Chapter Committees	Calvin H. Nelson
Management Services (Chairman)	Maurice B. T. Davies Alfred L. Hunt

Municipal Accounting	David H. Brodie
Nominating Committee	Claude R. Giles
	Milton J. Hoffman
Personnel	Clarence E. Olson
Practitioners' Emergencies	Calvin H. Nelson
Professional Development	Robert S. Warner
Reporting Standards	James E. Hammond
Tax Accounting Conference (Chairman)	Joseph J. Hyde
Taxation	Joseph J. Hyde

Los Angeles Chapter

Board of Directors, Member	George R. Sullivan

Committees

Accounting and Auditing Procedures	David A. Oxley
	Robert S. Warner
Accounting Systems	John W. Johnson
Admissions	Alan May, Jr.
Aircraft and Electronics Industry Accounting	John Everett Morris
Bylaws and Resolutions	Milton J. Hoffman
Cooperation with Credit Grantors	Milton J. Hoffman
Educational Standards and Student Relations	David V. Burgett
	Norman A. Erickson
	Frank Y. Garrison, Jr.
	John R. Thomas
Entertainment Industry Accounting	John W. Kennedy, Jr.
	Louie M. Bradley
Accounting Practices Subcommittee (Chairman)	Louie M. Bradley
Governmental Accounting and Auditing	Robert J. Borgmann
Hospitality and Member Attendance (Chairman)	John W. Johnson
	Herbert J. McClanahan
Internal Communications Aspects of Public Relations (Chairman)	Milton J. Hoffman
Legislation	Edwin B. Cassidy
Management Services	Maurice B. T. Davies
Meetings and Programs	Milton J. Hoffman
Membership	Herbert J. McClanahan
Nominating (Chairman)	Robert S. Warner
Professional Conduct	James J. Falls, Jr.
	Victor L. Liotta
Professional Development (Chairman)	Robert S. Warner
	Victor L. Liotta
Public Relations	Milton J. Hoffman
Taxation	Madonna E. Newburg
	Paul D. Yager
Technical Discussion Group	Sherman L. Harper

San Francisco Chapter

Director	Clarence E. Olson

Committees

Accounting and Auditing of Labor Unions and Welfare Funds (Chairman)	Roy Nordman
Accounting and Auditing Procedures	David A. Biasotti
Admissions	George H. Carter Thomas T. Giles
Attendance and Hospitality	Charles K. Denman Martin E. Gill
Cooperation with Credit Grantors (Chairman)	Donald W. Schroeder Joseph J. Hyde Richard K. Powers
Educational Standards and Student Relations	Donald G. Perry Edward N. Tormey, Jr.
Management Services (Chairman)	Alfred L. Hunt
Practitioners' Emergency Committee	Calvin H. Nelson
Practitioners' Problems	Morgan Benezra
Professional Conduct	Calvin H. Nelson
Professional Development (Chairman)	Claude R. Giles
Programs	Robert L. Jessee Calvin H. Nelson
Taxation	Martin J. Hanlon L. Robert Van Geffen

CONNECTICUT SOCIETY OF CPAs

State Committees

Cooperation with State	John R. Berthoud
Federal Taxes	Richard L. Denney
Taxation	Richard L. Denney

DISTRICT OF COLUMBIA INSTITUTE OF CPAs

Committees

Taxation	William T. Barnes Henry B. Jordan

ILLINOIS SOCIETY OF CPAs

President	Leo V. Tinkham

State Committees

Admissions	Edward A. Bowen
Auditing Procedure and Accounting Principles	Glenn E. Wabel
Chapter Activities	J. Warren Rowland
Federal Taxation	William F. Sheehan
General Meetings (Chairman)	Ernest R. Wish
Illinois SEC	Claireen L. Molzan
Legislation, Policy Subcommittee	Lawrence E. Frazee
Liaison with AICPA	Leo V. Tinkham
Local Governmental Accounting	Edward J. Rudnicki

Membership	Thomas J. Rownd
Special Campaigns Subcommittee (Chairman)	Alfred T. Dent
Personnel	John D. Muth
Professional Development (Vice-Chairman)	George H. Kern
Public Service and Information, Policy Subcommittee	Edward J. Rudnicki
State Auditing and Accounting (Vice-Chairman)	Louis J. Schaumburg
State Taxation	Carl D. Rolfsen
Study Conference, 1962	William R. Richards
Technical Meetings (Chairman)	Joseph E. Tansill
	Louis H. Peterson
	Francis A. Gallagher
Unprofessional Conduct (Chairman)	Robert W. Myers

Northern Chapter

Vice-Chairman	Francis A. Gallagher

Committees

Chapter Activities (Delegate)	J. Warren Rowland
Cooperation with Other Groups	Burton E. Lindgren
Legislation	Lawrence E. Frazee
Meetings	Ray H. Oleson
Professional Development (Coordinator)	Francis A. Gallagher

KENTUCKY SOCIETY OF CPAs

State Committees

Attendance and Reception	Norris E. Krall
Cooperation with Bankers	Curtis J. French
Educational Institutions, Subcommittee	Thomas K. Baer
Management Services	Harold W. Glore
Public Relations and Publicity (Director)	Louis S. Sorbo
State Taxation (Director)	Louis S. Sorbo

MARYLAND ASSOCIATION OF CPAs

Vice-President	H. C. Chinlund

State Committees

Accounting and Auditing Procedures	A. R. Ransom, Jr.
Attendance and New Members	D. W. Pfoutz
Chapter Formation	H. C. Chinlund
Management Services	J. A. Engel, Jr.
Publicity and Public Relations	L. P. Deering

MASSACHUSETTS SOCIETY OF CPAs

Vice-President	Herman Stuetzer, Jr.

State Committees

Accounting and Auditing Procedure	Alvin H. Carley
Bylaws and History	Mark C. Walker
Cooperation with Small Business Administration (Chairman)	Francis E. Moore
	Joseph P. Moore

Education (Chairman)	Edward W. Higbee
	William R. Wilson
Estate Planning	Robert S. Lappin
Ethics	Roger I. Lee, Jr.
Legislature	Joel D. Harvey
Management Services	Wallace J. Burgess
Membership	Vincent R. Collins
Nominating	Edward W. Higbee
Program	Roscoe E. Irving
Publications	Eugene M. Freedman
Tax Program	J. Paul Finnegan

MICHIGAN ASSOCIATION OF CPAs

State Committees

Accounting and Auditing Procedures	John J. Fox
	Lynn W. Hobbs
Federal Taxation (Chairman)	Eldin H. Glanz
Graduate Study Conference	Gordon A. Nethercut
Legislation Advisory	Clifford J. Code
Management Services	John J. O'Donnell, Jr.
Membership	Earl W. Reynolds
Personnel	William H. Dausey
Professional Education	Geraldine F. Dominiak
Professional Ethics	Allen Wear
Public Service and Information	Robert L. Pobur
Relations with Attorneys	Albert P. Teetzel, Jr.
Relations with Bankers	Edward J. Premo
Relations with Educators (Co-Chairman)	Edward E. Bolle
State Taxation	Jerome Y. Halperin
Unauthorized Practice	A. Karl Scharff

MISSOURI SOCIETY OF CPAs

Council Member	Carlin D. Oliphant

State Committees

State Taxation	John D. Mains

Saint Louis Chapter, Committees

Organization Bylaws	Carlin P. Oliphant
State and Municipal Taxation (Chairman)	John D. Mains

NEW JERSEY SOCIETY OF CPAs

Trustee	R. Kirk Batzer

Committees

Auditing and Accounting Principles and Procedures	Robert W. Egner
	Joseph N. Fina
Conference with Bench and Bar	Mark E. Richardson

Federal Taxation	Ernest L. Blackwell
Professional Development	William A. Mitchell
Programs (Chairman)	R. Kirk Batzer

Bergen County Chapter, Committees

Professional Development	Robert W. Egner
Programs	William A. Mitchell

NEW YORK STATE SOCIETY OF CPAs

First Vice-President	Mark E. Richardson

Committees

Accounting for Non-Profit Organizations	Robert M. Leng
Accounting Machinery	Herbert Bader
Accounting Procedure	Reed L. Colegrove
Administration of Accountants' Practice	Alfred J. Krupka
Administration of Society Office	Philip L. Defliese
Admissions	William T. Harrison
Advisory Committee to the State Comptroller	R. Kirk Batzer
Appointments, Advisory Committee (Chairman)	R. Kirk Batzer
Banks and Savings Institutions Accounting	John A. Hilbert
Committee Operations	R. Kirk Batzer
Contractors' Accounting	Robert M. Leng
Cooperation with Bankers	Louis H. Rappaport
Cooperation with Commercial Credit Grantors	Edmund A. Staub
Cooperation with Investment Bankers and Security Dealers	George E. Doty
Cooperation with Other Societies	Raymond G. Ankers
Cooperation with State Authorities	George E. Doty
Cooperation with the Bar	Carl J. Simon
Cost Accounting and Inventory Methods	Victor F. St. Thomas
Education and Personnel	William A. Mitchell
Education, Members in the Field	Horace J. Landry
Employee Benefit Plans	Robert H. Kaiser
Entertainment and Sports Accounting	William J. Neary
Estate Planning	Sidney Kess
Foreign Trade Accounting	John Leighton
Furtherance	Mark E. Richardson
Governmental Accounting	Alvin J. Mentzel
Hotel, Club and Restaurant Accounting	William F. Fyfe
Insurance Companies and Agencies Accounting	Norman E. Cusworth
International Taxation (Chairman)	Julian Phelps
Labor Union Accounting	Durwood F. Morgan
Legislation	Henry C. Elfers
Management Advisory Services	Willard F. Heffernan
Meetings	Reed L. Colegrove
Natural Business Year	Ernest J. DuBois
New York State Taxation	Herbert J. Brown
Other State Taxation	Anthony P. Rua
Petroleum Industry Accounting	Edmund A. Staub

Professional Conduct (Chairman)	George E. Doty
Professional Development	Norman E. Auerbach
Publications (Chairman)	Carl J. Simon
Public Relations	Robert W. Egner
Public Utilities Accounting	J. Edward Burke
Real Estate Accounting	Louis C. Moscarello
Retail Accounting	William J. McHugh
Staff Accountants	Dean H. Terwilliger
Statistical Sampling	Francis J. Schaefer
Stock Brokerage Accounting	Ernest C. Janson
Textile Accounting	James V. Regan

Richmond Chapter, Committees

Cooperation with Accountancy of Educational Institutions	Robert M. Leng
Professional Conduct	Robert M. Leng

Syracuse Chapter

Executive Committee Member	James P. Scott

Committees

Cooperation with Accountancy of Educational Institutions (Chairman)	Horace J. Landry
Cooperation with Bankers (Chairman)	James P. Scott
Meetings	Horace J. Landry

OHIO SOCIETY OF CPAs

Director	Robert S. Streng

State Committees

Accountants Liability Insurance (Chairman)	Lewis S. Spees
Accounting Principles	Ruth Ford
Constitution and Bylaws (Vice-Chairman)	Abner J. Starr
Cooperation with Accountancy Board of Ohio (Chairman)	James N. Buccalo
CPA Legislation	John C. Martin
Exhibits	Andrew J. Thomas
Long Range Planning (Chairman)	Leonard L. Hopkins
Management Services (Chairman)	Robert L. Starks
Meetings	John C. Padgett
Municipal Income Taxes	John H. Robb
Nominations	James N. Buccalo
Press and Publicity	Stanley E. Walker
Public Relations, Governmental (Chairman)	Willis K. Waterfield

Cincinnati Chapter

Vice-President	Paul M. Whitman

Committees

Accounting Personnel	Paul M. Whitman
Auditing Procedures	Jerome E. Kennedy
Attendance	Ronald F. Henke
Constitution and Bylaws (Chairman)	Abner J. Starr
	Robert W. Davis
Federal Taxation	Norman J. Lew
History of Ohio Society	Abner J. Starr
Management Services	Virgil L. Hundley
Meetings and Programs, Professional (Chairman)	William L. Louder
Press and Publicity (Chairman)	Stanley E. Walker
Public Relations, Governmental (Chairman)	Willis K. Waterfield
State Taxation	Emil E. Fleck, Jr.

Cleveland Chapter

President	Edwin P. Noell

Committees

Accounting Education	James L. Wamsley, Jr.
Auditing Procedures	Gilbert J. Barker
Civic Affairs	Andrew J. Thomas
Comments (Chairman)	Katherine E. Pfeifer
	Robert L. Hanak
Constitution and Bylaws	James P. Colleran
Estate Planning	Alberigo N. Volpe
Golf and Sports	Chester J. Kree
Management Services (Chairman)	Robert L. Starks
Public Relations	William D. Armstrong
Services to Local Practitioners	John P. Buleza

Columbus Chapter

Directors	Lewis S. Spees
	Robert S. Streng

Committees

Accountants Liability Insurance (Chairman)	Lewis S. Spees
Accounting Principles (Chairman)	Ruth Ford
CPA Legislation (Chairman)	John C. Martin
Municipal Income Taxes	John H. Robb
Nominations (Chairman)	James N. Buccalo

OKLAHOMA SOCIETY OF CPAs

State Committees

Constitution and Bylaws	T. W. McKibben
Professional Development	M. H. Fellers
Professional Ethics	H. O. Reyburn
State Convention, 1962 (Chairman)	P. S. Lovoi
Entertainment	M. H. Fellers

Tulsa Chapter

Executive Vice-President	P. S. Lovoi

Committees

Community Chest Solicitations	Robert E. Howard
Nominations	T. W. McKibben
Program	P. S. Lovoi

OREGON SOCIETY OF CPAs

State Committees

Cooperation with Banks and Other Credit Grantors (Chairman)	Roy H. Webster
Tax Forum	Robert L. Bergner
	Roy H. Webster

PENNSYLVANIA INSTITUTE OF CPAs

Vice-President and Executive Committee	Philip J. Taylor

State Committees

Annual Meeting	Edward B. Hastings
Auditing and Accounting Procedures	Roger F. Burd
Budget and Finance (Chairman)	John L. Moneta
Cooperation with Bankers and Other Credit Grantors	Joseph P. Wallace
Cooperation with the Bar	James E. Gelbert
Education	Robert F. Hartman, Jr.
Insurance Trust (Chairman)	Edward P. Mullen
Legislation	Edward B. Hastings
	George C. Rattelman
Legislation, Advisory Subcommittee (Regional Chairmen)	George A. Hewitt
	Britton H. Miller
(Member)	James D. McMenamin
Legislative Policy	Harry C. Zug
Local Government Auditing and Accounting	Edward Guion, Jr.
	George C. Rattelman
Long Range Objectives	Harry C. Zug
Management Advisory Services	Fred W. Replogle
Advisory Subcommittee	Francis J. DiIenno
Membership, Subcommittee for Pittsburgh Chapter	Ralph R. Crosby, Jr.
Nominations	Harry C. Zug
Past Presidents	George A. Hewitt
	Harry C. Zug
Professional Ethics (Chairman)	Ralph P. Kulzer
Public Relations Advisory Subcommittee	Jerome J. Lane
Relations with Schools and Colleges (Vice-Chairman)	Kenneth P. Johnson
Taxation (Vice-Chairman)	Richard T. Farrand
Advisory Subcommittee	John W. Heastings

Philadelphia Chapter

Vice-President	Edward P. Mullen
Executive Committee	Robert S. Haas

Committees

Attendance and Reception	Thomas E. Heney, Jr.
Committee Appointments (Chairman)	Edward P. Mullen
Continuing Education	Frederick J. Wonsetler
Cooperation with Credit Grantors	George L. Simmon
Cooperation with Members Not in Public Practice	Harry C. Schmidt
General Meetings (Vice-Chairman)	Robert F. Hartman, Jr.
Management Services	Francis J. DiIenno
Member Advisory Service	Edward Guion, Jr.
Newspaper and Machine Publicity	Leon Daniels
Nominations	Robert S. Haas
Social Activities (Chairman)	Edward F. Habermehl
Speakers Bureau	Burton L. Tacke
Taxation and Cooperation with Local Government	Hubert Brink, Jr.
Technical Meetings (Chairman)	Robert S. Haas

Pittsburgh Chapter, Committees

Accounting and Auditing Technical Sessions	Ralph R. Crosby, Jr.
Accounting Symposium	Edward B. Hastings
Annual Dinner Dance	H. Martin Westfall
Attendance and Reception	Anthony P. Spagnol
Cooperation with Educators	Joseph P. Wallace
Cooperation with Local Governments and Authorities	George C. Rattelman
Hospital Accounting and Auditing	Harry G. Lightcap, Jr.
Junior Achievement	Anthony P. Spagnol
Meetings with Joint Groups (Chairman)	Kenneth P. Johnson
Management Advisory Services	Fred W. Replogle
Radio and Television	John W. Heastings
Selection of Committees	Ralph P. Kulzer
Tax Topics	John W. Heastings

TEXAS SOCIETY OF CPAs

State Committees

Accounting Procedure, Petroleum Industry Subcommittee	S. L. Bires
Annual Meeting, 1962	C. E. Patton
Auditing Procedures (Chairman)	J. K. S. Arthur
	Louis J. Stow
Bylaws (Chairman)	J. M. Conder
Editorial Board, *Texas CPA*	G. W. Welsch
CPAs Consultants Program	J. K. S. Arthur
Long Range Planning	J. K. S. Arthur
Management Services (Consultant)	C. W. Phillips

Professional Development	J. M. Conder
Tax Consultant (Consultation Program)	G. W. Welsch
Tax Institute	G. W. Welsch

Dallas Chapter

Director	J. K. S. Arthur

Committees

Accounting Procedures (Chairman)	S. L. Bires
Long Range Planning (Chairman)	J. K. S. Arthur
Management Services	C. W. Phillips
Programs	Louis J. Stow
Writers Bureau (Chairman)	G. W. Welsch
News Bulletin and Texas CPA (Chairman)	G. W. Welsch

Houston Chapter, Committees

Community Service	W. P. Crouch
Cooperation with Bankers and Other Credit Grantors	C. E. Patton
Programs	W. P. Crouch

WASHINGTON SOCIETY OF CPAs

State Committees

Employment (Chairman)	B. K. Kittoe
Government Accounting	B. U. Krummel
Relations with the Bar	Harry W. Verhoef
Speakers' Bureau	Leon A. Holman
Publicity, Northwest Conference of CPAs (Chairman)	B. K. Kittoe

NATIONAL ASSOCIATION OF ACCOUNTANTS

National Director	T. W. McKibben

Committees

Eighth International Conference of Accountants (Chairman)	George A. Hewitt
Nominations (Chairman)	George A. Hewitt
Research Planning	James E. Meredith, Jr.

Ann Arbor Chapter (Michigan)

Programs (Director)	Earl W. Taylor

Birmingham Chapter

President	William W. Ragsdale
Programs (Director)	Frederick C. Deisher

Chicago Chapter

Newsletter (Editor)	Albert H. Degener

Cleveland Chapter

Systems and Procedures Seminars (Chairman) . .	Robert L. Starks
(Co-Chairman)	Chester J. Kree

Dallas Chapter

Regional Cost Conference, Publicity (Chairman) .	G. W. Welsch
Seminars (Associate Director)	G. W. Welsch

Detroit Chapter

Forward Planning	John J. Fox
Manuscripts (Associate Director)	John J. O'Donnell
Newsletter	Geraldine F. Dominiak
Programs (Director)	John J. Fox
Reception	Geraldine F. Dominiak
Team Captain	Richard W. Berkau

Hartford Chapter

Membership (Director)	Richard L. Denney

Los Angeles Chapter

Audit Committee	Herbert J. McClanahan
Communications (Associate Director)	Marshall M. Johnson
Junior Achievement Program, Special Activities	
(Associate Directors)	Harlan W. Loomas
	Herbert J. McClanahan
Area Co-Ordinator	Herbert J. McClanahan
Manuscripts (Director)	Frank Y. Garrison, Jr.

Louisville Chapter

Programs (Associate Director)	Frank G. Overton

New York Chapter

Vice-President	J. Edward Burke
Treasurer	Alfred J. Krupka

North Penn Chapter

Vice-President	William H. Lundquist
Meetings (Associate Director)	Joseph V. O'Donnell

Oakland County Chapter (Michigan)

Membership	Earl W. Reynolds

Orange County Chapter (California)

Member Attendance	David A. Oxley

Philadelphia Chapter

Vice-President	James D. McMenamin
Education (Associate Director)	Thomas E. Heney, Jr.
Member Attendance (Associate Director)	Robert H. Geer
Publicity (Associate Director)	Raymond L. Woodall, Jr.
Research Planning	Raymond L. Woodall, Jr.

Phoenix Chapter

Membership . . . . Bardon Maginnis

Pittsburgh Chapter

First Vice-President . . . . Joseph W. Bower
Business Show (Chairman) . . . . Joseph W. Bower
Membership (Associate Director) . . . . Kenneth P. Johnson

Portland Chapter

Special Activities (Director) . . . . Roy H. Webster

Rockford Chapter

Associate Director . . . . Ray H. Oleson

Saint Louis Chapter

Member Attendance (Assistant Director) . . . . Robert H. Miller
Publicity (Associate Director) . . . . John D. Mains

San Francisco Chapter

Secretary . . . . Donald G. Perry
Communications (Associate Director) . . . . . . David A. Biasotti
Seminars (Director) . . . . Alfred L. Hunt

South Jersey Chapter

Membership (Director) . . . . John T. Morris

Syracuse Chapter

Seminars (Director) . . . . Curtis G. James
Nominations (Chairman) . . . . Horace J. Landry

Tulsa Chapter

Communications . . . . Paul S. Lovoi

Washington, D. C. Chapter

Attendance (Director) . . . . William T. Barnes
(Associate Director) . . . . Henry B. Jordan
(Team Captain) . . . . Henry M. Chick

Notes

INTERNATIONAL

Some of our staff members of L.R.B. & M. are spending time in Coopers & Lybrand offices. Ernst Birthelmer (Cincinnati) is in Frankfurt and Robert A. Poons (Los Angeles) is in Geneva. Both men will be in training in these offices for a year.

David Fletcher Myles, a Chartered Accountant here from Sydney, Australia, recently left our Philadelphia office and is in our San Francisco office for six months.

George C. McDonald

We join with a host of our Canadian colleagues a deep sense of loss in the death last August of George C. McDonald, founder of McDonald, Currie & Co., a member firm of Coopers & Lybrand. Mr. McDonald was graduated from McGill in 1904, joined the Institute of Chartered Accounts in 1909, and in 1910 founded McDonald, Currie & Co.

LYBRAND TERRIBERRY

Mr. Frederick P. Sloat will continue as a member of the Society of Actuaries' committee on Experience Under Self-Administered Retirement Plans. Mr. Sloat has served on this committee since 1957.

BIRMINGHAM

Mr. Bill Goodner was Co-Chairman of the 15th Annual Joint Tax Clinic Committee at the University of Alabama in late September.

BOSTON

Mr. J. Paul Finnegan has been reelected as Treasurer for both the Scituate Harbor Yacht Club and the Old Colony Harvard Club.

Mr. Eugene M. Freedman has become a member of the National Association of Accountants.

Mr. Edward W. Higbee was elected Chairman of Capital Outlay Committee in the Town of Hingham.

CHICAGO

Mr. William R. Hindman recently served on the Audit Committee for the Benjamin Franklin School Parent-Teachers' Club of Park Ridge.

Mr. Leo V. Tinkham served as Treasurer of the 1961 Annual Meeting of the AICPA.

The following members of the Chicago staff passed the May, 1961 CPA examination:

Ralph W. Eilers	Alvin L. Goldberg
Jon D. Elletson	Harry E. Hindman
Thomas M. Garvin	Gail A. Shaw

Kenneth M. Vierck

CINCINNATI

Mr. James Cook has passed the Ohio CPA examination.

CLEVELAND

Mr. John P. Buleza has been elected Activities Chairman of the Cleveland Chapter of Fordham University Alumni Association.

Mr. James P. Colleran will be a member of the Federal Tax Committee of the Cleveland Chamber of Commerce.

On Election Day, Mr. Robert L. Starks won a two-year term on the City Council of Broadview Heights and he is also serving as a member and Secretary of the Board of Trustees, Broadview Heights Police Relief and Pension Fund. Mr. Starks is an elected Director of the Kiwanis Club of his community and recently served as Chairman of the 1961 Issues Committee of the Citizens League of Greater Cleveland.

The following staff members have successfully completed the CPA examination:

Andrew J. Thomas	November 1960
Robert L. Hanak	November 1960
Robert E. Highman	May 1961
Andre P. Provost	May 1961

DALLAS

Mr. A. B. Clark will serve the Institute of Internal Auditors as Chairman of the Social Committee for the coming year. Mr. Clark is also the Sergeant of Arms for the CPA Toastmasters Club.

Mr. G. W. Welsch was Panel Coordinator and Session Chairman at the Annual Tax Institute of the Texas Society of CPAs.

DETROIT

Mr. Maurice Allen is a member of the American Production and Inventory Control Society for the coming year.

Messrs. J. E. DeCaminada and Richard Dinsmore are members of the Detroit Bar Association for this year.

Mr. Frank R. Gilsdorf is President of the Catholic Accountants Guild of the Archdiocese of Detroit.

Mr. Jerome Halperin has been an instructor this fall for the Commercial Law Review at Wayne State University.

Mr. John O'Dell is a member of the Economic Club of Detroit.

LOUISVILLE

Mr. Thomas K. Baer is a National Director of the United States Junior Chamber of Commerce.

Hermon F. Bell

We report with regret the death, on September 19, 1961, of Hermon F. Bell. He was 81 years old.

Mr. Bell started his association with the Firm in 1913 and became a partner in 1929. His professional accounting career of more than forty years was devoted largely to the retail field, and in 1936 the first edition of his book, *Retail Merchandise Accounting*, was published. He also wrote a number of religious books including *An Introduction to Theology*, *Religion Through the Ages* and, most recently, in 1956, *Current Problems in Religion*.

He was born in Bristol, Rhode Island, and received a Bachelor of Arts degree from Amherst College in 1901 and the degree of Bachelor of Divinity from Yale Divinity School in 1905. He also did post-graduate work at Massachusetts Institute of Technology and Columbia University.

In addition to membership in various professional and business organizations, his club memberships included Accountants Club of America, National Republican Club, Amherst Club of New York and M.I.T. Club of New York, Inc. He had served as President of Phi Beta Kappa Alumni in New York and Treasurer of Phi Beta Kappa Associates. He also had been a Director of the Fiske Terrace Association for a number of years.

Mr. Bell is survived by his wife, Blanche, a daughter, Mrs. Robert H. Gould, and a sister, Miss Helen W. Bell.

NEW YORK

Mr. A. R. Jennings has become a charter member of the Advisory Council of Pace College.

The New York Society of CPA Candidates was formed in May, 1961. Raymond G. Ankers is currently serving as the group's first Director Representing the New York State Society of CPAs, and Robert H. Frey as the first President.

PHILADELPHIA

Mr. George A. Hewitt was honored by the Philadelphia Chapter of N.A.A. on his retirement as National President.

Dr. Enrique Menocal, former Cuban Minister of Finance, discussed the early days of the regime of Fidel Castro in Cuba in October at a meeting of the Philadelphia County Council, American Legion. He also wrote an article, "The Punta del Este Conference: Alliance for Progress" which appeared in two installments of *The Chestnut Hill Local* newspaper during September.

Mr. Edward P. Mullen was elected Treasurer of Aronimink Golf Club for the coming calendar year.

Mr. William R. Richards who, after twenty-five years of service to the Firm, retired at the end of September, received a television set from members of the staff and office personnel. Mr. Richards was presented with this gift by Mr. T. Edward Ross at the office. Mr. Richards was in charge of the assignment of staff personnel.

Mr. Gustave F. Schweitzer is Chairman of the Committee of Audit & Report for the United Fund of the Philadelphia Area.

Mr. Frederick J. Wonsetler was Seminar Coordinator for the Pennsylvania Institute Seminar on "Operations Research as A Management Tool," which was held in late October.

Mr. Raymond L. Woodall, Jr. is on the Board of Directors of the Main Line Junior Chamber of Commerce. He was Chairman of the Jaycees' Tenth Annual Clothesline Art Exhibit.

Mr. Harry C. Zug is serving the University of Pennsylvania as a member of the Advisory Committee for the Fifth Year Program in Professional Accounting.

PITTSBURGH

Mr. Ralph P. Kulzer is Chairman of the Business Professions Group, Advance Gifts Phase of the Alumni Fund Drive for Duquesne University. Mr. Anthony P. Spagnol is a member of the committee.

ROCKFORD

The following members of the staff have passed the May CPA examination:

M. Dean Hamilton E. Roger Reithmeier

SAN FRANCISCO

Mr. David H. Brodie is Chairman of the Board of Managers for the San Francisco YMCA. Mr. Brodie was in charge of the meeting of the Finance Officers of the Salvation Army in late September.

Mr. Edward N. Tormey, Jr. will act as Treasurer of the Green Meadow Community Association of Palo Alto.

SEATTLE

Mr. R. L. Aiken is a member of the Board of Trustees and Chairman of the Budget Committee of the Plymouth Congregational Church.

Mr. Leon A. Holman is a member of the Finance Committee for the Messiah Lutheran Church and will continue to serve in this capacity until 1964.

Mr. B. U. Krummel is Vice-President of the German Old People's Home Association of Seattle, as well as Secretary-Treasurer of the CPA Toastmasters. Mr. Krummel is serving as a member of the Finance Committee for Group Health Cooperative Association, and is a member of the Seattle Chamber of Commerce Committee on State and Local Taxation.

Mr. Paul H. Palmer has received his CPA Certificate.

1961 TAX CONFERENCE

WHAT can a member of the Firm's staff expect from a three-day tax conference? Joseph E. DeCaminada (above left) of the Detroit office finds the answer after opening day breakfast as he studies the seven-page agenda prepared by Philip Bardes, National Director of Tax Services. Mr. DeCaminada was one of 125 participants in the October conference held in the Poconos. He was especially interested in the Estate Planning Seminar, where (above right with Norman J. Lew) he raises a specific situation, involving a Detroit client, for general discussion and suggestions. The first morning featured a report on the latest tax developments in

Washington from William T. Barnes and Henry B. Jordan (at left). The second day opened with a discussion of Employee Benefit Plans, chaired by Robert D. Collins of the Lybrand Terriberry Division (below right

with Arthur F. Parry and William T. Barnes). This was followed by a discussion on the Tax-Free Reorganization Provisions, with Chairman Raymond E. Graichen, shown (standing, right) with Francis A. Gallagher, Frances B. Rapp, James E. Gelbert and Dallas Blair-Smith. On the closing day, John J. McCullough led the session on Tax Planning, which he discusses afterwards (below left) with three partners from the Columbus office. Pictured (l. to r.) are John H. Robb, McCullough, John W. Curl, and Clarence C. Gattner. These were only a few of many sessions which,

Mr. DeCaminada and others agreed, combined to make a rather full three days. Next year's conference is scheduled for October at Split Rock Lodge in Pennsylvania's Pocono Mountains.